No. 89-1106-CSX
Status: GRANTED

Title: Trinova Corporation, Petitioner
v.
Michigan Department of Treasury

Docketed:
January 16, 1990

Court: Supreme Court of Michigan

Counsel for petitioner: Sheldon,Peter S.

Counsel for respondent: Casey,Thomas L., Caruso,Louis J.

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1	Jan 16 1990	G	Petition for writ of certiorari filed.
2	Feb 12 1990		Brief of respondent Michigan Department of Treasury in opposition filed.
3	Feb 14 1990		DISTRIBUTED. March 2, 1990
4	Feb 20 1990	X	Reply brief of petitioner Trinova Corporation filed.
5	Mar 5 1990		Petition GRANTED.
			**********
7	Mar 15 1990		Order extending time to file brief of petitioner on the merits until April 27, 1990.
8	Mar 15 1990	G	Motion of petitioner to dispense with printing the joint appendix filed.
9	Mar 26 1990		Motion of petitioner to dispense with printing the joint appendix GRANTED.
10	Apr 27 1990		Brief of petitioner Trinova Corporation filed.
11	Apr 27 1990		Lodging received.
12	Apr 27 1990		Brief amicus curiae of Caterpillar Inc. filed.
14	Apr 27 1990		Brief amici curiae of Alcan Aluminum Corp., et al. filed.
16	May 17 1990		Order extending time to file brief of respondent on the merits until June 13, 1990.
17	Jun 13 1990		Brief amici curiae of Council of State Governments, et al. filed.
18	Jun 13 1990		Brief of respondent Michigan filed.
19	Jul 2 1990		CIRCULATED.
20	Jul 13 1990	X	Reply brief of petitioner Trinova Corporation filed.
21	Jul 23 1990		SET FOR ARGUMENT MONDAY, OCTOBER 1, 1990. (3RD CASE)
22	Aug 21 1990		Record filed.
		*	Certified original record received from Supreme Court ofMichigan.
23	Aug 22 1990		Record filed.
		*	Certified record received. (2 boxes).
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89-1106

No. 89-

Supreme Court, U.S.
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CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

TRINOVA CORPORATION,
Petitioner,

v.

STATE OF MICHIGAN,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF MICHIGAN

Of Counsel:
BENJAMIN O. SCHWENDENER, JR.
ALAN M. VALADE
SCHWENDENER & VALADE, P.C.
Dart Management Building
Mason, Michigan 48854
(517) 676-5137

WILLIAM F. SHEEHAN
COLLETTE C. GOODMAN
SHEA & GARDNER
1800 Massachusetts Ave., N.W.
Washington, D.C. 20036
(202) 828-2000

WALTER HELLERSTEIN
Professor of Law
University of Georgia
School of Law
Athens, Georgia 30602
(404) 542-5175

PETER S. SHELDON
(Counsel of Record)
THOMAS D. HAMMERSCHMIDT, JR.
JEFFERY V. STUCKEY
DICKINSON, WRIGHT, MOON,
VAN DUSEN & FREEMAN
215 S. Washington Square
Lansing, Michigan 48933
(517) 371-1730

Counsel for Petitioner

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTIONS PRESENTED

The Michigan Single Business Tax Act imposes a tax, nominally on the "privilege of doing business" within the State, measured by the "value added" by the taxpayer to the goods and services it buys. The Act's "value added" tax base consists of the taxpayer's compensation paid to all its employees, in and out of state, its total depreciation and interest payments, and its profit. The Act determines the portion of this value deemed to have been added in Michigan by apportioning the tax base according to the three-factor formula of payroll, property, and sales that is widely used to apportion state income taxes. The application of that formula to petitioner, an Ohio company, attributed to Michigan 39 times more compensation than petitioner actually paid in Michigan, and 970 times more depreciation than petitioner actually incurred in Michigan.

The questions presented are:

1. Whether application to petitioner's value-added tax base of the three-factor formula used for apportioning state income taxes results in a tax on value actually added outside the state and produces a grossly distorted result, in violation of the Due Process and Commerce Clauses.

2. Whether the Michigan tax discriminates against out-of-state businesses in favor of in-state businesses by employing an apportionment formula that, in the vast majority of cases, irrationally reduces the tax base of the latter and increases the tax base of the former.

LIST OF PARTIES AND RULE 29.1 STATEMENT

Petitioner is the corporate successor to Libby-Owens-Ford Company, which commenced this action. Apart from the respondent, there were no other parties to the proceedings below. Petitioner's subsidiaries are these:

Aeroquip Automotive, Inc.

Aeroquip Gmbh

Aeroquip International, Inc.

Aeroquip Vickers de Brasil, S.A.

Custom Trim of Michigan, Inc.

Korea Vickers Systems Co., Ltd.

Microfuel Systems, Inc.

Sterling INOAC Co.

Toyo Joint Co., Ltd.

Vickers of India, Limited

Vickers Kawasaki Controls KK

Vickers Systems Gmbh
(Belgium, The Netherlands, and Switzerland)

Vickers Systems, Inc.

Zaverchand Gaekwad Private Ltd.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

No. 89-——

TRINOVA CORPORATION,
Petitioner,

v.

STATE OF MICHIGAN,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF MICHIGAN

OPINIONS BELOW

The opinion of the Supreme Court of Michigan (App. 1a) is reported at 433 Mich. 141, 445 N.W.2d 428 (1989). The order of the Supreme Court of Michigan denying rehearing (App. 29a) is reported at 433 Mich. 1203 (1989). The opinion of the Michigan Court of Appeals (App. 30a) is reported at 166 Mich. App. 656, 421 N.W.2d 258 (1988). The opinion and order of the Michigan Court of Claims (App. 42a) is unreported.

JURISDICTION

The judgment of the Supreme Court of Michigan was entered on August 21, 1989. Petitioner's timely petition for rehearing was denied on October 16, 1989. (App. 29a.) The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Due Process Clause of the Constitution, Amend. XIV, § 1 provides: "[N]or shall any state deprive any person of life, liberty, or property, without due process of law."

The Commerce Clause of the Constitution, Art. I, § 8, cl. 3 provides: "The Congress shall have Power to regulate Commerce with foreign Nations, and among the several States, and with Indian Tribes."

Relevant portions of the Michigan Single Business Tax Act, Mich. Comp. Laws § 208.1 *et seq.*, are set forth at App. 59a-62a.

STATEMENT

For a multistate taxpayer with business activities in Michigan, the Michigan Single Business Tax Act establishes a "value-added" tax measured by the value that the taxpayer is regarded as having added, within the state, to the selling price of its final products. The major components of added value are the costs to the business enterprise of labor (compensation costs) and capital (depreciation and interest costs). The Michigan statute taxed petitioner, an Ohio corporation, by determining the value purportedly added in Michigan through an apportionment formula that attributed to Michigan 3,900% more compensation than petitioner actually paid in the State, and 97,000% more depreciation than petitioner actually incurred in the State. Petitioner contends that the Act violates the Due Process and Commerce Clauses because, as applied to Petitioner, the tax is imposed upon value added almost entirely outside of Michigan, and because it impermissibly discriminates against out-of-state corporations.

Notwithstanding the profoundly different characteristics of a value-added tax from an income tax, the Michi-

gan Supreme Court treated the case as if it were just another income tax case. It assumed without discussion, and in our view wrongly, that individual elements of value added, like elements of corporate income, cannot accurately be traced to the state in which they are generated, and it endorsed without analysis, again in our view wrongly, the use of the three-factor property, payroll, and sales formula that is typically used for apportioning net income. On that footing it concluded that the tax assessed against petitioner was not wholly disproportionate to petitioner's business activity within the State, and was accordingly constitutional. The Court did not address petitioner's additional claim that the tax is discriminatory.[1]

"Various aspects of state tax systems based on the 'unitary business' principle and formula apportionment have provoked repeated constitutional litigation in this Court." *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159, 163-64 (1983) (citing cases). So far as we know, however, the Court has never considered a value-added tax. This kind of tax is not common in this country and it is necessary to understand how it differs from an income tax to appreciate why a constitutional analysis good for one is not good for the other.

1. The Nature of a Value Added Tax.

The tax may be easiest understood if it is assumed to have been adopted by a state to apply to a taxpayer which adds all the value to its product within the taxing state.[2] With respect to a final product or service that is

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[1] Behind this case in the Michigan courts lie hundreds of other cases, with well over $100 million at stake, brought by taxpayers most of whom, like petitioner, are out-of-state companies whose principal business activity in Michigan consists of marketing. See App. 74a.

[2] See generally Haughey, *The Economic Logic of the Single Business Tax*, 22 Wayne L. Rev. 1017 (1976); Kleine, *The Michigan Single Business Tax: A Different Approach to State Business*

delivered to the ultimate consumer, portions of the value of that product or service have been contributed by each of the several enterprises in the chain of corporations through whose hands it may have passed in the course of production. For example, a clothing manufacturer purchases material and through the use of its labor and capital equipment fabricates various articles of clothing. The product, a suit or a dress, say, has a value greater than the materials purchased. That value is attributable to the cost of the labor and capital and the value of the entrepreneurial effort—reflected in profit—contributed by the manufacturer.

The process continues through the wholesaler and on to the retailer who makes the final sale to the consumer. The tax is imposed on the value added by each company in the chain. In the aggregate it is imposed on the value of the final company's product or service (*e.g.*, the retail price of the dress), which will be the sum of the values added by each company along the way. Of course in some cases there may be only one taxpayer in the chain while in others there may be many. In every case the total tax base, whether attributed to one taxpayer or among many, is theoretically equal to the price paid by the consumer for the final product.

As we explain further below, the Michigan statute, like the example just given, starts from the premise that the value contributed by a taxpayer comes from three principal sources—first from work done by its employees, second from the portion of its capital plant that is consumed during the applicable period, and third from its profit, which compensates it for the entrepreneurial skills that have contributed to the final product. The first two items are easily quantified. The total compensation paid by the taxpayer represents the value of the labor contribution. The amount of depreciation of its capital as-

Taxation, Advisory Commission on Intergovernmental Relations (1978).

sets and the interest paid to others represents the capital contribution. Determination of the third item, profit, is more complex but it too may be ascertained. The sum of the three items, in addition to measuring the value added by the taxpayer, also becomes, in the case of a state tax applied to a company whose activities are entirely in one state, the tax base to which the tax rate is applied.

But complexities arise from the application of Michigan's statute to out-of-state enterprises. To be sure, a taxpayer that makes substantial sales to consumers within the state but has no employees or engages in no other business activities within the state may escape tax altogether.[3] But it is different when such a taxpayer establishes a taxable presence within the state through a few employees who support its sales efforts and perform modest services for its customers. That, indeed, is an accurate description of petitioner. Most of its business activities take place entirely in Ohio. In 1980 the total compensation paid to its employees was $226,356,271; of that amount $511,774, or 0.2%, was paid to its 14 employees in Michigan. App. 54a. Its depreciation amounted to $23,262,909; the depreciation of its Michigan assets was $2,152, or 0.009%. App. 55a. Petitioner suffered a net loss in that year, and so no part of the value it added to its products was attributable to profit.

We turn now to a fuller description of Michigan's value-added tax.

2. Michigan's Single Business Tax Act.

Michigan's Single Business Tax ("SBT") has been characterized by the Michigan Supreme Court as a consumption-type value added tax, *Mobil Oil Corp.* v. *Department of Treasury*, 422 Mich. 473, 373 N.W.2d 730 (1985), reflecting the fact that the tax is imposed pri-

[3] Cf. *National Bellas Hess, Inc.* v. *Department of Revenue*, 386 U.S. 753 (1967).

marily upon the value added to the goods and services purchased by the taxpayer through the consumption of capital and labor furnished by the taxpayer. In broad outline, and as applied to a taxpayer engaged in business within and without Michigan, the tax is calculated in essentially two steps. First a preapportionment tax base is established. Then the amount of value considered to have been added in Michigan is computed by means of the three-factor formula commonly used to apportion state income taxes, and, after certain other adjustments, the tax rate is applied to that amount.

a. *The preapportioned tax base.* Michigan computes the tax base by looking first to the activities of the taxpayer nation-wide, without regard to where they are conducted or the extent to which the activities are carried on within Michigan. The largest component of the tax base consists of compensation. The Act requires the taxpayer to include the total compensation paid to all employees, without regard to their locale or functions. Compensation includes, in addition to wages and bonuses, the value of fringe benefits not paid directly to employees, such as retirement plan contributions, health and welfare plan expenditures, and unemployment and social security taxes.

To compensation is added (to the extent they were deducted in arriving at federal taxable income) all depreciation, amortization, or write-offs of the cost of tangible assets, as well as interest, dividends, and royalties paid by the taxpayer. App. 11a. This component of the tax base reflects value added through the use of money or property in producing the taxpayer's goods or services.

Profit, called "busines income" by the SBT, the third item included in the aggregate value added, involves, as stated above, a more complex computation. Presumably for ease of administration and to reduce the need for verification, the SBT starts with the reported federal taxable net income. This is increased by certain amounts that are usually deducted in arriving at federal taxable

income but are regarded by the SBT as not appropriately deducted in computing annual business income, such as state income taxes paid, SBT taxes paid, and income on state debt obligations other than those of Michigan. On the other hand, investment income, including dividends, interest, and royalties received by the taxpayer, are deducted to the extent they were included in arriving at federal taxable income. App. 11a.[4]

These adjustments are often made in computing net income under state corporate income tax statutes, although it is instructive to note that investment income is deducted in the latter case because it is generally allocated to the domiciliary state rather than apportioned, whereas it is deducted from the tax base under a value-added tax because it does not represent any value added by the taxpayer to its products or services.

The profit component of the tax base is generally not quantitatively significant. The Michigan Department of Treasury has determined that, for all businesses subject to the tax, profit makes up less than 6% of the tax base. Compensation comprises 77%, and the remainder consists of other items, such as depreciation and interest.[5] There may of course be individual departures from the average—a capital intensive business, for example, would have a higher amount of depreciation and interest and a lower amount of compensation. Nevertheless, the SBT, like any other value-added tax, is essentially a tax on compensation paid and capital consumed during the taxable year.

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[4] There are other adjustments not mentioned here because they are irrelevant to the issues presented. See Mich. Comp. Laws § 208.9 (1979).

[5] *Analysis of the Michigan Single Business Tax*, Taxation and Economic Policy Office, Michigan Department of the Treasury, Table 4, p. 27 (Jan. 1985). Petitioner relied on and made this analysis available to the courts below. *E.g.*, Brief on Appeal in the Michigan Supreme Court, filed July 8, 1988, pp. 7-8 & n.2.

b. *The apportionment of value added to Michigan.* Once the tax base is established it is apportioned to Michigan according to a three-factor formula which weights payroll, property, and sales equally. Mich. Comp. Laws § 208.45 (1979). The formula is essentially the same as the familiar three-factor formula embodied in the Uniform Division of Income for Tax Purposes Act, 7A U.L.A. 336 (1957), which the Court has considered on numerous occasions in recent years.[6] It assumes that payroll, property, and sales contribute relatively equally to the production of income. See *Butler Bros.* v. *McColgan*, 315 U.S. 501, 507 (1942). Michigan has chosen the three-factor formula to apportion value added even though, as discussed below, sales make a negligible contribution to value added as compared to compensation and depreciation.

From the apportioned tax base the taxpayer is permitted to subtract an amount reflecting capital acquisitions (the Capital Acquisition Deduction, or "CAD"), and another amount designed to adjust for high labor compensation costs.[7] Further deductions are allowed for

[6] See, *e.g.*, *Container Corp.* v. *Franchise Tax Bd.*, 463 U.S. 159 (1983); *Exxon Corp.* v. *Department of Revenue*, 447 U.S. 207 (1980); *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425 (1980). "The three-factor formula yields a percentage representing an average of three ratios: property within the State to total property, payroll within the State to total payroll, and sales within the State to total sales." *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 270 n.3 (1978).

[7] The CAD reflects the value added concept that "profit" should be the amount retained after expenditures for capital assets, even though this is not the generally accepted accounting definition and such expenditures are not deducted in arriving at federal taxable income. The Michigan Court of Claims recently struck down the CAD as unconstitutional on the ground that it impermissibly discriminated against out-of-state businesses because it operated to favor businesses with all or most of their operations in Michigan. *Caterpillar Inc.* v. *Michigan*, Nos. 84-9664-CM and 87-11109-CM (opinion and order entered July 13, 1989, final judgment entered Aug. 11, 1989), appeal pdg., Mich. Ct. App. No. 119584.

specified businesses. Tax at the rate of 2.35% is then imposed on the resulting "adjusted tax base." Mich. Comp. Laws § 208.31 (1979).

3. The Tax Assessed Against Petitioner.

This case was decided by the courts below on the basis of the parties' Stipulated Facts. App. 52a-58a. The chart below, reflecting those facts, shows, in the left-hand column, the components of petitioner's 1980 tax base ($221,125,319). The right-hand column shows the amount of the tax base apportioned to Michigan by the application of the three-factor property, payroll, and sales formula.

	Tax Base	Apportioned Tax Base (8.9717%)
Compensation	226,356,271	20,308,006
Depreciation	23,262,909	2,087,078
Interest, Dividends and Royalties Paid	22,908,950	2,055,322
Adjusted U.S. Taxable Income (Loss)	(42,466,114)	(3,809,932)
Subtract: Dividends, Interest & Royalties Received	(9,486,223)	(851,076)
Other additions	549,526	49,302
Tax Base	$221,125,319	$19,838,700
Apportionment		
Property Factor	.0930%	
Payroll Factor	.2328%	
Sales Factor	26.5892%	
Average Factor	8.9717%	
Apportioned Tax Base	$ 19,838,700 (221,125,319×8.9717%)	

As the chart shows, petitioner's compensation apportioned to Michigan was $20,308,006. Yet actual compensation paid to employees performing services in Michigan was only $511,774. App. 54a. Hence petitioner's apportioned Michigan compensation overstated its actual Michigan compensation by 39 times, or 3,900%. Petitioner's

apportioned Michigan depreciation was $2,087,078 compared to its actual depreciation on property located in Michigan of $2,152. App. 55a. Hence petitioner's apportioned Michigan depreciation was overstated by 970 times, or 97,000%.

Petitioner's apportioned tax base of $19,838,700 was adjusted by subtracting the Capital Acquisition Deduction and by the reduction allowed to compensate for high labor compensation costs, yielding an adjusted tax base of $12,492,671 and a 1980 tax, at 2.35%, of $293,578 before credits.[8]

4. The Jones & Laughlin Decision.

In 1985 a panel of the Michigan intermediate court of appeals ruled that a taxpayer conducting business both within and without Michigan, who in all relevant respects was similarly situated to petitioner, was entitled to relief under § 69 of the Act. That so-called "relief provision" permits a taxpayer, when the apportionment provisions of the Act do not fairly represent the extent of its business in Michigan, to petition for use of another method of apportionment to effect an equitable allocation and/or apportionment of the tax base. *Jones & Laughlin Steel Corp.* v. *Department of Treasury*, 145 Mich. App. 405, 377 N.W.2d 397 (1985), *leave to appeal and reconsid. den.*, 424 Mich. 895 (1986). See App. 63a-72a.

Like petitioner, the taxpayer in that case had a tax base comprised almost entirely of compensation; its actual compensation paid in Michigan could be determined accurately; and application of the statutory formula resulted in an apportionment of compensation to Michigan

[8] The statutory adjustment for high labor costs, found in Mich. Comp. Laws § 208.31(4), permits an SBT taxpayer a deduction to the extent that its compensation divided by its tax base exceeds 63%. See App. 13a, n.13.

that was multiples higher than the amounts directly allocable to the state. The court therefore allowed the taxpayer to apportion its tax base in an alternative fashion under § 69, namely, by excluding compensation from the tax base, applying the three-factor formula to the remaining tax base, and adding to that amount the actual amount of compensation directly allocable to Michigan. The decision was not based on constitutional grounds; rather, the court considered § 69 to provide relief whenever the results reached under the otherwise applicable statutory provisions were found to be unfair. App. 67a-68a, 71a.

5. The Proceedings Below.

Relying on *Jones & Laughlin*, petitioner requested § 69 relief and filed an amended tax return for 1980 seeking a refund. App. 7a. The Department of Treasury denied the request. App. 8a. Petitioner then sued, and prevailed, in the Michigan Court of Claims. App. 8a-9a. A different panel of the appellate court, however, rejected *Jones & Laughlin*'s interpretation of § 69 and reversed. App. 9a. The case then went to the Michigan Supreme Court.[9]

In that court the State acknowledged that out-of-state manufacturers "incur the majority of their wage costs

[9] Petitioner's complaint in the Court of Claims at ¶ 13 alleged that the tax as applied to it violated the Due Process and Equal Protection Clauses because of the misattribution of petitioner's tax base. That court did not reach any constitutional issue, ruling in petitioner's favor on the basis of its construction of § 69 of the SBT. In the Michigan Court of Appeals petitioner argued that the SBT as applied to it violated the Due Process and Commerce Clauses, Brief on Appeal, filed Dec. 21, 1987, at 20-26, although, as noted above, that court, too, based its ruling solely on the SBT. In the Michigan Supreme Court petitioner argued that, unless relief were available under § 69, petitioner would be subject to unconstitutional taxation of extraterritorial business activity in violation of both the Due Process and Commerce Clauses. Brief on Appeal, filed July 8, 1988, pp. 10-27.

outside of Michigan" and "their depreciation expense is related to factories which are outside of Michigan." It recognized that "[u]nder the *Jones & Laughlin* rationale, these expenses * * * are assigned to the out-of-state location." Defendant-Appellee's Brief on Appeal, filed Aug. 5, 1988, at 2. It also recognized that, if Michigan forthrightly imposed a tax directly on compensation, it "would apply to a tax subject so inherently locale-specific as to require specific allocation" to the state in which the compensation was paid. *Id.* 31. But it argued that the Michigan tax falls, not on compensation, nor depreciation, but on "value added," which is appropriately apportioned by the three-factor formula that is used to apportion net income for purposes of state income taxes. *Id.* 19-26.

The Michigan Supreme Court upheld the tax. It said that the Act taxes "business activity," which includes "the complete range of entrepreneurial activities of which compensating employees is but one part." App. 22a. "Consequently," the Court said,

> "to conclude that a taxpayer's business activity is not fairly apportioned because a single component of that activity, when examined by geographical accounting, is not accurately reflected under the statutory apportionment scheme belies the very definition of business activity." *Id.*

Like the State, however, the Michigan Supreme Court had to acknowledge that the "single component" at issue—compensation—accounted for "a substantial portion of the tax base in most businesses", and the entire portion in petitioner's case. *Id.* But the Court refused to consider whether compensation or depreciation can be clearly identified on a geographical basis—or, more precisely, whether the value added by those elements of added value can be thus identified, leaving the profit element to be apportioned. Instead it simply ruled that apportionment of the aggregate value-added tax base was constitutionally acceptable, relying principally on an income tax case, *Container Corp.* v. *Franchise Tax Bd.*, 463 U.S. 159, 164 (1983).

There this Court held that California was not required, in imposing its income tax on a unitary business with foreign subsidiaries, to account separately for income from the subsidiaries because "separate [geographical] accounting * * * may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.'" 463 U.S. at 181 (inner quotations omitted; bracketed material in original).

The Michigan Supreme Court adopted that analysis and without discussion assumed that "the failings of separate accounting" in income tax cases would necessarily bedevil and require apportionment in value added cases as well. App. 23a, n. 24. The Court thus accepted the income tax apportionment formula and concluded that the tax assessed against petitioner, when judged against its overall "business activity" conducted in the state, was constitutional:

> "Trinova's actual Michigan compensation was $511,774, and its actual property as reflected in its depreciation expense was $2,152. While these figures obviously represent a very small percentage of Trinova's total business activity, they are offset by its Michigan sales figure of $103,081,354. When viewed as a whole, we believe the average ratios of Trinova's payroll, property, and sales 'actually reflect a reasonable sense of how [its Michigan business activity was] generated,' clearly satisfying the constitutional requirements of internal and external consistency." App. 24a-25a (bracketed material in original; footnote omitted).

The Court did not explain, in holding that petitioner's receipt of $103,981,354 for products it delivered in Michigan "offset" its Michigan compensation and depreciation figures, what value to petitioner's product was added by those deliveries. It did not consider, for example, whether the Michigan sales were the result of marketing and sales efforts made by petitioner's employees (elements of added value already reflected in compensation) or whether they were the result of the consumption of capital (already reflected in depreciation). Rather, the Court seemed to assume that the fact of delivery in Michigan of goods worth $103,981,354 meant that $103,981,354 worth of value to the sold products was actually added in Michigan. The bizarre result of the Court's mechanical application of an income tax apportionment formula to a value-added tax base was that almost 10% of petitioner's value adding activities were attributed to Michigan, even though virtually none of those activities was conducted in Michigan.[10]

REASONS FOR GRANTING THE WRIT

A state tax on multistate corporations must pass "the four-pronged test originated in" *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977). *Goldberg* v. *Sweet*, 109 S. Ct. 582, 587 (1989). The tax will survive constitutional challenge if it "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." 430 U.S. at 279. This Court "repeatedly [has] applied this principle in subsequent cases" (*Amerada Hess Corp.* v. *New Jersey Taxation Division*, No. 87-453, Slip op. at 6 (Apr. 3, 1989)), but never to a value-added tax.

[10] In 1987 the State enacted 1987 PA 39, which amended the Act effectively to overrule *Jones & Laughlin* by providing that the apportionment provisions of the Act shall "fairly represent business activity attributed to the taxpayer in this state, taken as a whole and without a separate examination of the specific elements of the tax base such as depreciation, compensation, or income * * *." App. 75a. As we have seen, the Michigan Supreme Court's decision in this case did overrule *Jones & Laughlin* and construed the *preamended* SBT to preclude examination of the components of the tax base. Hence the decision makes the amendment redundant. Accordingly, we believe that, if this Court were to rule that the SBT as construed below is unconstitutional, the amendment could not save it. In any event, the Court below made no determination regarding the amendment. See App. 27a, n.29.

The Michigan SBT as construed by the Michigan Supreme Court fails the second and third prongs of the *Complete Auto* test. As we show below, the tax is not fairly apportioned because, with respect to its most significant components—compensation and depreciation—it should not be apportioned at all. That is because the value added by those components is capable of precise location inside and outside the State. Moreover, even if it were appropriate to apportion the tax base, the formula chosen by the State—and in particular the inclusion of the sales factor—yields an unconstitutionally distorted result. There is no theoretical or practical justification for including a sales factor in the apportionment formula, since no value is added to the taxpayer's goods by the mere act of delivering them into the State. The manner in which the tax base is constructed and the economic justification for the tax combine to show that only a trivial addition of value can be attributed to this activity. Yet the inclusion of a sales factor apportions to Michigan compensation and depreciation costs which, as the State has stipulated, exceed petitioner's actual Michigan costs by 3,900% and 97,000%, respectively.

We also show below that the tax is discriminatory, and fails the third prong of the *Complete Auto* test, because it prefers taxpayers whose labor force and physical plant are located within the state to taxpayers whose labor force and plant are located without the state. Use of the sales factor causes compensation and depreciation of

Michigan manufacturers to be wrongly exported out of the state (and out of the SBT tax base) while wrongly importing into the state (and into the tax base) the compensation and depreciation of out-of-state taxpayers.

The outcome of this case will affect hundreds of other multistate corporate taxpayers in over 400 pending cases with well over $100 million in the balance. It will influence the actions of other States in determining whether to adopt a value added tax, which produces revenue regardless of corporate profits.[11] For those reasons, and because the decision below is fundamentally unsound as a matter of constitutional law and warrants correction, the Court should hear this case.

I. THE USE OF THE THREE-FACTOR FORMULA FOR APPORTIONING PROFITS TAXES VALUE ADDED OUTSIDE THE STATE AND PRODUCES A GROSSLY DISTORTED RESULT

A. The SBT Wrongly Apportions Value Added That Can Be Precisely Allocated Elsewhere.

The fair apportionment prong of *Complete Auto* restates the settled rule that extraterritorial taxes violate the Due Process and Commerce Clauses. *E.g. Norfolk & Western Ry.* v. *Missouri State Tax Comm'n*, 390 U.S. 317 (1968); *Butler Bros.* v. *McColgan*, 315 U.S. 501, 506 (1942); *Hans Rees' Sons* v. *North Carolina*, 283 U.S.

[11] Michigan's switch to the value added tax had several goals, among them (a) "to increase the stability of state business tax revenues over the business cycle * * * by abandoning profits as the principal business tax base", (b) "to establish a neutral tax system with each business paying taxes in proportion to its economic size", and (c) "to reduce the heavy burden of taxation on capital in Michigan [and thereby stimulate] job-creating capital investments in Michigan and expansion of demand for the goods and services of local market industries." Haughey, *supra*, at 1021-1022. These anticipated benefits may recommend a value-added tax to states other than Michigan.

123, 134 (1931) (state may not tax "profits which are in no just sense attributable to transactions within its jurisdiction."). In the case of an income-based tax, a state may not constitutionally " 'tax value *earned* outside its borders.' " *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159, 164 (1983) (emphasis added), *quoting ASARCO Inc.* v. *Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982). There can be no reason for a different constitutional rule for a value-added tax.[12] The SBT, however, taxes value that is *added* outside its borders. The reason, as we shall see, lies chiefly in the State's use of the three-factor formula for apportioning profit in income tax cases.

Formulary apportionment is justified by the conceptual and practical difficulties that preclude a precise determination of where the profit of a unitary multistate corporation is earned. As Justice Powell has explained, apportionment "owes its existence to the fact that with respect to a business earning income through a series of transactions beginning with manufacturing in one State and ending with a sale in another, a precise—or even wholly logical—determination of the State in which any specific portion of the income was earned is impossible." *Moorman Mfg.*, *supra*, 437 U.S. at 286 (Powell, J., dissenting).[13]

There is no justification for apportionment, however, when the geographic locus of a tax base can be identified

[12] "[I]f an apportionment method results in the taxation of a larger portion of the income, capital stock, property *or other tax base* than is properly attributable to the state, under established legal doctrine, the taxpayers' rights, protected by the Due Process Clause, have been infringed." Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business*, 21 Nat'l Tax J. 487 (1968) (emphasis added; footnote omitted).

[13] See also *ASARCO Inc.*, *supra*, 458 U.S. at 316-317; *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 120-121 (1920).

with precision. Thus there is no warrant for apportioning an ad valorem tax on real or immobile personal property, and no taxing jurisdiction in the country attempts to do so. Because the geographic situs of the property can be identified with precision, any attempt to determine the tax base by reference to a formula (containing factors other than the property itself) would necessarily lead to geographical misattribution of the tax base.

Furthermore, even when apportionment is generally an acceptable method of determining the geographic location of a tax base, a taxpayer may successfully challenge the application of a formula to its tax base if it can demonstrate that the formula leads to "a grossly distorted result." *Norfolk & Western Ry., supra*, 390 U.S. at 326. Thus, if the taxpayer can show what percent of income "actually had its source in the State", and the State's formula apportions to itself a significantly greater amount, the tax is unconstitutional. *Moorman Mfg. Co., supra*, 437 U.S. at 274, describing *Hans Rees' Sons, supra.*

The SBT, in adopting a formulary apportionment approach, wrongly assumes that the value added by the taxpayer's business activities cannot be specifically attributed to the states in which it conducts those activities, and, in so assuming, has in this case produced "a grossly distorted result." The assumption is wrong because the Act itself identifies the activities that add value, and the value that the two principal elements add can be located precisely where those activities themselves occur. In this respect the components of added value are conspicuously unlike the abstruse and elusive elements of profit that justify apportionment of net income.

As we have seen, a business adds value to its ultimate product principally through the efforts of its employees (reflected in their compensation), the dedication of its capital (reflected in depreciation and interest paid), and the entrepreneurial talents of its management (reflected,

one may hope, in profit). The SBT explicitly recognizes these "inputs" to added value by constructing a tax base reflecting compensation plus depreciation plus an adjusted "business income" (*i.e.*, profit).

With the exception of profit, which is an appropriate subject for apportionment for the same reasons it is apportioned in income tax cases, these inputs of added value are demonstrably different from the "factors of profitability" that contribute to a multistate corporation's income—such as "functional integration, centralization of management, and economies of scale." *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 438 (1980). Those abstract and conceptual factors confound the effort "to characterize the income of the business as having a single identifiable 'source.'" *Id.* The compensation and depreciation components of added value, by contrast, are concrete and can be located precisely. As the Michigan Supreme Court has said, the SBT taxes "the use of the resources of society". *Mobil Oil Corp. v. Department of Treasury, supra*, 422 Mich. at 494, 373 N.W.2d at 740. Those resources, petitioner's labor and petitioner's plant, were used where they were consumed—in this case almost entirely in Ohio. Their use added value to goods ultimately delivered in Michigan, but the delivery itself did not. The value had been added before and in Ohio, when and where the labor and plant were consumed. And the State itself has conceded that a tax on compensation —which, in petitioner's case, describes the SBT perfectly —would be required to be allocated to the state in which the compensation was paid. See p. 12, *supra*.

The Michigan Supreme Court reached its contrary result by stating that what Michigan really taxes is not value added, but instead an amorphous and indivisible concept called "business activity," which is no more geographically identifiable than the net income that most states tax under their corporate income taxes, and hence equally subject to apportionment. See p. 12, *supra*. But

this facile analysis cannot withstand constitutional scrutiny. As this Court has made clear, the touchstone of constitutional analysis of state taxes is "the practical effect of a challenged tax" (*Mobil Oil Corp. v. Commissioner of Taxes*, *supra*, 445 U.S. at 443) and "economic realities." *Complete Auto*, *supra*, 430 U.S. at 279. Accordingly, "[t]here is no economic consequence that follows necessarily from the use of the particular words 'privilege of doing business,' and a focus on that formalism merely obscures the question whether the tax produces a forbidden effect." 430 U.S. at 288. It is the same with the phrase "business activity": its use cannot obscure the question of forbidden effect. As we have shown above, the distinguishing feature of a value added tax such as Michigan's is that it is possible to identify precisely the components of the tax base, and to locate precisely the principal ones—compensation and depreciation. The Michigan Supreme Court cannot escape that conclusion by an *ipse dixit* which is simply inconsistent with the facts.[14]

The misguided assumption underlying the SBT's apportionment provisions—that compensation and depreciation cannot be precisely identified on a geographic basis

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[14] As two economists have written:

> "The standard three-factor formula used for determining what fraction of a multi-state firm's value added should be taxable under the SBT is a cumbersome method of arriving at the wrong answer. Since value added consists of payments to labor and to capital, whose location in both cases is relatively unambiguous, there is no reason why value added in Michigan should not be measured directly. Instead, the apportionment formula measures it indirectly and incorrectly * * * by giving weight to sales, which do not measure the employment of a factor of production, and hence are not a component of value added."

R. Barlow and J. Connell, Jr., *The Single Business Tax*, Michigan's Fiscal and Economic Structure, U. Mich. Press, 673 (Brazer, H., ed. 1982)

—has produced a constitutionally intolerable result in this case. In *Hans Rees' Sons*, *supra*, the state's apportionment formula attributed 85% of the taxpayer's income to North Carolina, as compared to a separate accounting analysis which attributed at most 21.7%. It was "the more than 250% difference which led [the Court] to strike down the [North Carolina] tax." *Container Corp. supra*, 463 U.S. at 184. Yet the SBT has apportioned $20,308,006 in compensation to Michigan when actual compensation to Michigan employees was $511,774, a difference of 3,900%. And the SBT has apportioned $2,087,078 in depreciation to Michigan when actual Michigan depreciation was $2,152, a difference of 97,000%. These figures are far beyond "the substantial margin of error inherent in any method" of apportioning income of a multistate company, *id.*, and condemn the tax.

B. The Three-Factor Formula Produces a Grossly Distorted Result.

Even if, contrary to the foregoing, the State was right in apportioning rather than allocating petitioner's compensation and depreciation, the result is unconstitutional because the apportionment to Michigan of the value added by petitioner's consumption of labor and capital is "'out of all appropriate proportions to'" petitioner's business transacted in Michigan and has "'led to a grossly distorted result.'" *Container Corp., supra*, 463 U.S. at 170. These results are caused by the State's unthinking adoption of the three-part formula used to apportion income taxes.

The three-factor property, payroll, and sales formula, which is now "'something of a benchmark against which other apportionment formulas are judged'" (*Amerada Hess Corp., supra*, Slip op. at 7), was approved by the Court in *Butler Bros., supra*, on the ground that those three factors—

> "reflect 'the relative contribution of the activities in the various states to the production of the total unitary income,' so as to allocate to California its just proportion of the profits earned by appellant from this unitary business." 315 U.S. at 509.

These things cannot be said of the formula as applied to value added, for the chief reason that the sales factor does not in fact or theory make remotely the same contribution to value as payroll and property. Because of that its inclusion in the formula can lead to stunning distortions, as it has here, for the following reasons.

The sales factor in the formula as applied to petitioner in fact measures deliveries in the state, not actual sales.[15] There is no value added by the delivery *per se*. Any value added associated with the delivery is to be found in the wages of the deliverers (if they are petitioner's employees), which is already accounted for in the payroll factor.[16] Yet, for a business like petitioner's, with large deliveries in the state but small amounts of actual compensation and depreciation—the major components of value added—the inclusion of the sales factor produces a grotesque misapportionment. Petitioner's payroll factor (Michigan payroll over total payroll) was .2328%. Its property factor was .0930%. Those two factors, reflecting the major portions of added value, average .1629%, a percentage which, when applied to petitioner's tax base of $221,125,319, yields an apportioned tax base of $360,213. When the sales factor of 26.5892% is added, however, the average jumps over 55 times to 8.9717%, and the apportioned tax base to $19,838,700.

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[15] Petitioner's shipments of goods to Michigan customers are shipped F.O.B. Ohio. Thus, under the Uniform Commercial Code, the transfer of title takes place in Ohio. Mich. Comp. Laws § 440.2401(2)(a) (1979).

[16] If the deliveries are made by an independent transportation company, the employees' wages will be reflected in the compensation component of the value added tax base of that company.

The distortion would remain even if title passed in Michigan and the sales factor did measure sales rather than deliveries. Sales can add value in only two ways—through the compensation paid to employees engaged in sales efforts, and through profit to the extent that the sales include a markup. But the value added by compensation to salespersons will already be in the tax base and apportioned through the payroll factor and should not be duplicated by the sales factor. The remaining value added—profit—generally accounts, as we have seen, for a minor percentage of total added value, and does not deserve equal footing with the major items of payroll and property. Indeed, in petitioner's case, since it suffered a loss, there was no value added in the form of profit whatsoever. Yet inclusion of the sales factor in the formula meant the difference between an adjusted tax base of $360,213 and $19,838,700.

This Court has declined to annoint any particular formula as, in the abstract, constitutionally required or forbidden. *E.g., Moorman Mfg., supra.* But it has been equally insistent that, whatever formula is chosen, it must be "fair", meaning among other things that "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." *Container Corp., supra*, 463 U.S. at 169. In the case of a value added tax, the factors must actually reflect a reasonable sense of how value is added. Yet here, as we have shown, they do not, because of the erroneous inclusion of the distorting sales factor.[17]

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[17] This Court has noted, albeit not in a constitutional context, that the three-factor formula "can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates. By contrast, the geographic distribution of a corporation's sales is, by itself, of dubious significance in indicating the locus of either factor." *General Motors Corp.* v. *District of Columbia*, 380 U.S. 553, 561 (1965).

II. THE SBT DISCRIMINATES AGAINST OUT-OF-STATE BUSINESSES

"[T]he Commerce Clause prohibits a State from imposing a heavier tax burden on out-of-state businesses that compete in an interstate market than it imposes on its own residents who also engage in commerce among States." *American Trucking Ass'ns, Inc.* v. *Scheiner*, 483 U.S. 266, 282 (1987); *Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. 318, 335 (1977). The SBT's compliance with this prohibition must be analyzed in light of its overall operation and purposes, for, "in its guarantee of a free trade area among States * * * the Commerce Clause has a deeper meaning that may be implicated even though state provisions * * * do not allocate tax burdens between insiders and outsiders in a manner that is facially discriminatory." *American Trucking*, *supra*, 483 U.S. at 282.

Before Michigan adopted the SBT it had an income tax which, of course, did not tax compensation but instead treated it as a deduction in arriving at the income tax base. In replacing the income tax with the SBT, the legislature "intended to reduce the heavy burden of taxation on capital in Michigan".[18] The decreased burden on capital intensive industries was expected to encourage more capital investment in Michigan and stimulate the state's economic growth—*i.e.*, "to promote the development and investment of business within Michigan." App. 73a (inner quotation and footnote omitted). But it also results in an "increase [in taxes] for firms in labor intensive industries."[19] More important, it does so in a manner that systematically reduces the tax base of businesses located principally within the state that sell their products elsewhere while systematically increasing the tax base of businesses located principally outside the state that sell their products in Michigan.

[18] Haughey, *supra*, at 1022. The intended and practical effect of the SBT is discussed in detail in Haughey, at 1021-1024. See also Kleine, *supra*, at 39-43.

[19] Haughey, *supra*, at 1022.

The SBT's systematic discrimination in favor of local and at the expense of out-of-state businesses is the inexorable consequence of the application of the familiar three-factor apportionment formula, with a sales factor, to a tax base comprised almost entirely of compensation and depreciation and interest. The point can be made with a simple example. Assume two businesses, a "Michigan business" and an "Ohio business," each with a total SBT tax base of $1,500,000, comprised, as Michigan's statistics tell us, of 77% compensation, 6% profit, and the remaining 17% of such items as depreciation and interest. If the Michigan business has 98% of its property and payroll in Michigan, and 60% of its sales in Michigan, application of the three-part formula will attribute 14.67% of its compensation outside the state.[20] If the Ohio business has 98% of its payroll and property in Ohio, but 40% of its sales in Michigan, the three-part formula will attribute 14.67% of its compensation to Michigan.[21]

Thus the Ohio business, with virtually none (only $23,100) of its compensation in Michigan, will be taxed on $169,439 of the value added by the labor of its employees. The Michigan business, with virtually all its compensation ($1,131,900) in Michigan, will have $169,439 of the value added by its labor attributed out of

[20] The arithmetic is: 98% payroll in Michigan plus 98% property in Michigan plus 60% sales in Michigan=256%, which divided by 3=85.33% attributed to Michigan, and the remaining 14.67% attributed out of state.

[21] Thus: 2% payroll plus 2% property plus 40% sales=44%, which divided by 3=14.67% attributed to Michigan.

state and *not* taxed in Michigan.[22] Thus for the Ohio business the formula attributes $146,339 *more* compensation to Michigan than it actually pays to its Michigan-based employees, while attributing for the Michigan business $146,339 *less* compensation to its Michigan employees than it actually pays those employees.[23] If we prolonged the example by figuring the formula's effect on the depreciation component of the tax base, we would find similar results. For both taxpayers the three-part formula not only attributes amounts to the wrong place, but also does so in a way that reduces the tax base for Michigan-based companies while increasing it for out-of-state companies.

This result brings the SBT squarely within the reach of this Court's decisions striking down other discriminatory state taxes. *American Trucking* held that Pennsylvania's flat taxes "discriminate against out-of-state vehicles by subjecting them to a much higher charge per mile traveled in the State" than the comparable charge on local vehicles. *Id.* at 290. The Court ruled that, since the taxes "impose a cost per mile on appellants' trucks that is approximately five times as heavy as the cost per mile borne by local trucks, the taxes are plainly discriminatory." *Id.* at 286. Michigan's SBT likewise discriminates against out-of-state businesses by imposing on them a far greater tax burden per dollar of actual value added

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[22] Calculated as follows: The compensation component (77%) of the $1,500,000 tax base is $1,155,000, of which 14.67% is $169,439. For the Ohio company, however, with only 2% of its payroll in Michigan, actual Michigan compensation would be $23,100 (2% of $1,155,000). For the Michigan company, with 98% of its payroll in Michigan, actual Michigan compensation would be $1,131,900 (98% of $1,155,000).

[23] For the Ohio business, the difference between actual compensation of $23,100 and attributed compensation of $169,439 is $146,339. For the Michigan company the figures are $1,131,900 of actual compensation and $985,561 of attributed compensation ($1,155,000 less $169,439), also yielding a difference of $146,339.

in Michigan than the tax imposes on taxpayers with their labor force and physical plant located principally within the state.

Similarly, in *Maryland* v. *Louisiana*, 451 U.S. 725, 757 (1981), the Court invalidated a Louisiana tax scheme on the ground that its "obvious economic effect * * * is to encourage natural gas owners involved in the production of [Outer Continental Shelf] gas to invest in mineral exploration and development within Louisiana rather than to invest in further OCS development or in production in other States." And *Westinghouse Elec. Corp.* v. *Tully*, 466 U.S. 388 (1984), struck down a New York statute which provided a greater tax credit for export activity originating in, rather than out of, the state. The Court ruled that "[w]hether the [New York credit] diverts new business into the State or merely prevents current business from being diverted elsewhere, it is still a discriminatory tax * * *." 466 U.S. at 406. Like the defective taxes in those cases, the SBT, because of its reliance on an inappropriate apportionment formula, impermissibly pressures interstate businesses to shift their operations to Michigan. See *Tyler Pipe Indus.* v. *Department of Revenue*, 483 U.S. 232, 243 (1987); *Boston Stock Exchange*, *supra*, 429 U.S. at 329.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

Of Counsel:
BENJAMIN O. SCHWENDENER, JR.
ALAN M. VALADE
SCHWENDENER & VALADE, P.C.
Dart Management Building
Mason, Michigan 48854
(517) 676-5137

WILLIAM F. SHEEHAN
COLLETTE C. GOODMAN
SHEA & GARDNER
1800 Massachusetts Ave., N.W.
Washington, D.C. 20036
(202) 828-2000

WALTER HELLERSTEIN
Professor of Law
University of Georgia
School of Law
Athens, Georgia 30602
(404) 542-5175

PETER S. SHELDON
(Counsel of Record)
THOMAS D. HAMMERSCHMIDT, JR.
JEFFERY V. STUCKEY
DICKINSON, WRIGHT, MOON,
VAN DUSEN & FREEMAN
215 S. Washington Square
Lansing, Michigan 48933
(517) 371-1730

Counsel for Petitioner

January 16, 1990

APPENDIX

APPENDIX

MICHIGAN SUPREME COURT

Docket No. 82673

TRINOVA CORPORATION

v.

DEPARTMENT OF TREASURY

(Calendar No. 10)

Argued November 2, 1988 Decided August 21, 1989

Trinova Corporation, an Ohio-based corporation whose business activity in Michigan included $103,981,354 in sales, but only a small sales office, filed an amended tax return claiming a refund of its small business tax for 1980 and seeking permission to use an alternative method of apportionment under § 69 of the Single Business Tax Act similar to the method approved by the Court of Appeals in *Jones & Laughlin Steel Corp v Dep't of Treasury*, 145 Mich App 405 (1985). The requested tax-base apportionment would have resulted in a negative adjusted tax base, thereby reducing Trinova's tax liability to zero for 1980. Both the refund and apportionment relief were denied. Thereafter, Trinova brought an action in the Court of Claims against the Department of Treasury, seeking the requested apportionment relief and a refund of its claimed 1980 Single Business Tax overpayment. The court, Robert Holmes Bell, J., relying on *Jones & Laughlin*, ordered the refund on the basis of the alternative apportionment formula. The Court of Appeals, MAHER, P.J., and SHEPHERD and K. TERTZAG, JJ., reversed in an opinion per curiam, finding that relief un-

der § 69 was available only where application of the apportionment formula resulted in an unfair representation of the taxpayer's Michigan-based business activity taken as a whole, concluded that 1987 PA 39, which amended § 69 to restrict the availability of apportionment relief in response to *Jones & Laughlin*, was intended to apply retroactively, and remanded the case for further factual development and reconsideration in light of 1987 PA 39 (Docket No. 100641). The plaintiff appeals.

In an opinion by Justice BOYLE, joined by Chief Justice RILEY, and Justices BRICKLEY, CAVANAGH, ARCHER, and GRIFFIN, the Supreme Court *held:*

Apportionment relief under § 69 of the Single Business Tax Act may obtain upon a showing by the challenging party of clear and cogent evidence that the business activity attributed to the state is out of all appropriate proportion to the taxpayer's intrastate business activity or has led to a grossly distorted result.

1. The single business tax is a form of value added tax, although it is not a pure value added tax. Rather, it is a tax upon business activity. Its intended effect is to impose a tax upon the privilege of conducting business activity within Michigan, not upon income. The tax is computed by determining the taxpayer's tax base, and then allocating the value earned to the state where the business activity of the taxpayer can be fairly attributed. Apportionment relief under § 69 may be obtained if the apportionment provisions of the act do not fairly represent the extent of the taxpayer's business activity in this state. The central purpose of any apportionment provision is to ensure that each state taxes only its fair share of an interstate transaction. To preserve the constitutionality of the act, § 69 allows the use of an alternate method of apportionment if the apportionment provisions result in an unconstitutional taxation of a unitary business.

2. Generally, a state may not tax value earned outside its borders. An apportionment formula must be fair under both the Due Process and Commerce Clauses. It must be internally and externally consistent, resulting in no more than one-hundred percent of the taxpayer's business activity being taxed, if all taxing jurisdictions employed the same formula, and must reflect a reasonable sense of how the business activity is generated. An apportionment formula will not be deemed unfair if it *may* result in taxation of some business activity that did not have its source in the taxing state. It will be held to be externally inconsistent only upon a showing by the taxpayer of clear and cogent evidence that the business activity attributed to the state is out of all appropriate proportion to the business transacted in that state or has led to a grossly distorted result. In *Jones & Laughlin*, the Court of Appeals erred in concluding that the apportionment provisions of the act failed to fairly represent the extent of the taxpayer's business activity because the formula distorted one element of the activity, in considering the filing of an amended return to be a petition for the purpose of securing relief under § 69, and in the approving an alternate apportionment formula without prior approval of the commissioner.

3. In this case, although the petitioner sought apportionment relief under § 69 on the ground that the act's apportionment formula failed to accurately represent its Michigan business activity, it was not shown by clear and cogent evidence that the statutory apportionment provisions attributed business activity to Michigan that was out of all proportion to the petitioner's business actually transacted in Michigan or has led to a grossly distorted result. Viewed as a whole, the apportionment reflects a reasonable sense of the petitioner's actual Michigan business activity, clearly satisfying the internal and external consistency requirements.

Affirmed with modification.

Justice LEVIN, writing separately, stated that this case, together with the several hundred other cases pending in the Court of Claims, should be remanded for a hearing on the factual issues adverted to in the briefs of the parties and the amici curiae and in the opinion of the Court.

166 Mich App 656; 421 NW2d 258 (1988) affirmed.

Jones & Laughlin Steel Corp v Dep't of Treasury, 145 Mich App 405; 377 NW2d 397 (1985) overruled.

TAXATION—SINGLE BUSINESS TAX ACT—APPORTIONMENT RELIEF.

Apportionment relief under § 69 of the Single Business Tax Act may obtain upon a showing by the challenging party of clear and cogent evidence that the business activity attributed to the state is out of all appropriate proportion to the taxpayer's intrastate business activity or has led to a grossly distorted result (MCL 208.69; MSA 7.588[69]).

Dickinson, Wright, Moon, Van Dusen & Freeman (by *Ernest Getz* and *Peter S. Sheldon*) and *Schwendener & Valade, P.C.* (by *Benjamin O. Schwendener, Jr.*, counsel), for the plaintiff.

Frank J. Kelley, Attorney General, *Louis J. Caruso*, Solicitor General, and *Richard R. Roesch*, Assistant Attorney General, for the defendant.

Amici Curiae:

Miller, Canfield, Paddock & Stone (by *Samuel J. McKim III, P.C., Julianna B. Miller*, and *Robert F. Rhoades*) and *Honigman, Miller, Schwartz & Cohn* (by *James H. Novis* and *William G. Christopher*) for Trinova Corporation.

Foster, Swift, Collins & Coey, P.C. (by *Lawrence B. Lindemer* and *Patrick R. Van Tiflin*), for Advanced Technology Laboratories, Inc.

McDermott, Will & Emery (by *John S. Pennell, Don S. Harnack, Richard A. Hanson*, and *Gregory G. Palmer*) for Caterpillar Inc.

Clark, Klein & Beaumont (by *Dwight H. Vincent, J. Walker Henry, Thomas S. Nowinski, Curtis J. Mann*, and *Joseph A. Bonventre*) for Michigan Manufacturers Association.

William H. Crabtree, General Motors Corporation (by *E. Alan Moorhouse*, of counsel), and Ford Motor Corporation (by *John M. Neberle*, of counsel) for Motor Vehicle Manufacturers Association of the United States, Inc.

OPINION OF THE COURT

BOYLE, J. In this case we are called upon to determine the proper standard for the granting of tax base apportionment relief § 69[1] of the Single Business Tax Act, MCL 208.1 *et seq.*; MSA 7.558(1) *et seq.*, when a taxpayer claims that the apportionment provisions of the act fail to fairly represent the extent of the taxpayer's business activity within this state. The Court of Appeals in *Jones & Laughlin Steel Corp v Dep't of Treasury*, 145 Mich App 405; 377 NW2d 397 (1985), lv den 424 Mich 895 (1986), determined that § 69 apportionment relief is appropriate when any one element of the taxpayer's business activity, as represented in its adjusted tax base, is not accurately reflected under the statutory apportionment formula, notwithstanding the fairness of the resulting apportionment. The *Jones & Laughlin* Court also approved of an alternate two-step apportionment/

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[1] In the event that the statutory apportionment provisions fail to "fairly represent the extent of the taxpayer's business activity in this state," § 69 provides that upon the petition of the taxpayer or insistence of the Commissioner of Revenue, an alternate method of apportionment may be used if reasonable and if approved by the commissioner.

allocation method [2] whereby the taxpayer's tax base was apportioned under the standard formula exclusive of the § 9 adjustment for compensation expense. The taxpayer's actual compensation expense was then directly allocated to determine the taxpayer's adjusted tax base. We are asked to review the propriety of this rule.

After due consideration, we reject the *Jones & Laughlin* rule. To determine whether the apportionment provisions of the act fairly represent the extent of a taxpayer's Michigan business activity a reviewing court or tribunal must first find, upon a showing of clear and cogent evidence by the challenging party, that the total business activity attributed to Michigan is out of all ap-

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[2] As part of the tax base computation, § 9(5) calls for the addition of compensation as defined in MCL 208.4(3); MSA 7.558(4)(3). See MCL 208.9(5); MSA 7.558(9)(5). Section 4(3) defines "compensation" as:

"Compensation" means all wages, salaries, fees, bonuses, commissions, or other payments made in the taxable year on behalf of or for the benefit of employees, officers, or directors of the taxpayers and subject to or specifically exempt from withholding under section 3401 of the internal revenue code. Compensation includes, on a cash or accrual basis consistent with the taxpayer's method of accounting for federal income tax purposes, payments to state and federal unemployment compensation funds, payments under the federal insurance contribution act and similar social insurance programs, payments, including self-insurance, for workmen's compensation insurance, payments to individuals not currently working, payments to dependents and heirs of individuals because of current or former labor services rendered by those individuals, payments to a pension, retirement, or profit sharing plan, and payments for insurance for which employees are the beneficiaries, including payments under health and welfare and noninsured benefit plans and payments of fees for administration of health and welfare and noninsured benefit plans. Compensation does not include discounts on the price of the taxpayer's merchandise or services sold to the taxpayer's employees, officers, or directors which are not available to other customers or payments to an independent contractor.

propriate proportion to the actual business transacted in this state or leads to a grossly distorted result. The *Jones & Laughlin* Court erroneously concluded that the apportionment provisions of the act failed to fairly represent the extent of the taxpayer's total business activity because the formula distorted *one* element of that activity.

We find greater wisdom in this Court of Appeals panel's rejection of the *Jones & Laughlin* rule: Since the final apportionment percentage is the *average* of three component percentages (property, payroll, and sales), it will in all cases be larger than at least one of the component percentages unless by fortuity all of the components are equal. Thus, the *Jones & Laughlin* rule transforms the § 69 relief provision into an all-purpose tax equity provision. We agree with this Court of Appeals panel and reject that construction of § 69. We affirm with modification the decision of the Court of Appeals reversing the Court of Claims and remanding this matter for further proceedings.

I

FACTS

Trinova is an Ohio-based corporation which manufactures and distributes automobile components nationwide. Its activity in Michigan is confined primarily to a small sales office employing fourteen office and clerical workers who solicit sales orders for Trinova's glass division and who also provide liaison with its Michigan customers. For the tax year 1980, Trinova's sales in Michigan totaled $103,981,354, constituting over twenty-six percent of its total sales. Under the act, Trinova was assessed a tax of $293,528 which it paid.

Approximately one month after the Court of Appeals decided *Jones & Laughlin*, *supra*, Trinova timely filed with the state an amended tax return claiming a refund of its single business tax for the year 1980. Trinova also

sought permission to use an alternative method of apportionment under § 69, similar to that approved in *Jones & Laughlin*.[3] Trinova's requested 1980 tax base apportionment would have resulted in a *negative* adjusted tax base of $2,042,458, reducing its tax laibility for that year to zero.[4] Trinova's refund and apportionment relief request was denied.

Trinova then filed suit in the Court of Claims, seeking the apportionment relief previously requested, as well as $293,528 it claimed as an overpayment for 1980.[5] On

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[3] In the Court of Claims, Judge Bell recognized this deficiency in Trinova's claim for § 69 relief. He concluded, however, that because such a defect was noted in the *Jones & Laughlin* case, but was not found to foreclose § 69 relief, similar treatment of Trinova was justified.

[4] Trinova's requested apportionment calculations provided:

Tax base		221,125,319
Deduct: Compensation	226,356,271	
Depreciation	23,262,909	249,619,180
Total		(28,493,861)
Apportionment 8.9717%		(2,556,384)
Add: Michigan compensation		511,774
Michigan depreciation		2,152
Allocated and apportioned tax base		(2,042,458)

[5] The state filed a counterclaim in the Court of Claims, alleging that the single business tax formula failed to fairly represent "the extent of Plaintiff's use of the State of Michigan as a market for its products," and "the significant amount of receipts which plaintiff derives from its business activities in Michigan." The state offered an alternative one-factor formula based entirely upon Trinova's Michigan sales. The state argued that Trinova's actual sales amounted to $103,981,354, but that its estimated sales under the act were only $35,196,000. Thus, the state offered that its one-factor formula was substantially more accurate than that envisioned under the act or the formula offered by Trinova.

The court rejected the state's claim as a greater distortion of Trinova's Michigan business activity than that which resulted under the act's formula. The court acknowledged that Trinova's formula

cross motions for summary disposition, the Honorable Robert Holmes Bell agreed with Trinova that the statutorily provided apportionment formula did not fairly represent its 1980 business activity and ordered the state to accept Trinova's amended tax return for the year 1980. Relying on the reasoning of the Court of Appeals in *Jones & Laughlin*, Judge Bell further ordered the refund of any overpayment and interest due on the basis of Trinova's alternative apportionment formula.

The Court of Appeals reversed the decision of the Court of Claims, specifically rejecting the analysis of the *Jones & Laughlin* court. The Court concluded that relief under § 69 "was available only where application of the apportionment formula resulted in an unfair representation of the taxpayer's Michigan-based business activity taken as a whole." *Trinova v Dep't of Treasury*, 166 Mich App 656, 663; 421 NW2d 258 (1988). The Court further concluded that 1987 PA 39 was intended to apply retroactively, *id.*, p 665, but did not reach the issue as to whether retroactive application of 1987 PA 39 was constitutional. Rather, the case was remanded to the Court of Claims for further factual development and reconsideration in light of 1987 PA 39.

Trinova appealed that ruling to this Court, and we granted leave to appeal. 430 Mich 876 (1988).

II

INTRODUCTION

Our resolution of this dispute does not require that we scrutinize the mechanics of the Single Business Tax Act in detail. However, to appreciate the issues raised on appeal, a basic understanding of the components and workings of the single business tax will be helpful. The

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was not perfect, but found it to be superior to that provided under the act or offered by the state. It appears that the state did not pursue its counterclaim on appeal.

single business tax is a form of value added tax, although it is not a pure value added tax. *Town & Country Dodge, Inc v Dep't of Treasury*, 420 Mich 226, 234; 362 NW2d 618 (1984).[6] "Value added is defined as the increase in the value of goods and services brought about by whatever a business does to them between the time of purchase and the time of sale."[7] In short, a value added tax is a tax upon business activity. The act employs a value added measure of business activity, but its intended effect is to impose a tax upon the privilege of conducting business activity within Michigan. It is not a tax upon income. MCL 208.31(4); MSA 7.558(31)(4).

Value added, or business activity, is subject to calculation by two equivalent methods. The first method begins with the taxpayer's gross receipts from which all outside purchases are subtracted. The residual figure represents the value added by the internal operations of the taxpayer. The second method is additive. All internal payments representing factors of production such as wages, rent, interest, together with the taxpayer's profit are totaled and constitute the value added by the taxpayer's efforts.[8] The act employs a modified additive method of value added computation. *Mobil Oil Corp v Dep't of Treasury*, 422 Mich 473, 495-497; 373 NW2d 730 (1985).

The computation of the tax involves several steps beginning with the calculation of the taxpayer's tax base.[9]

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[6] The single business tax is considered not to be a pure value added tax because of various exclusions, exemptions, and industry-specific adjustments that were adopted by the Legislature when the tax was enacted. See Haughey, *The economic logic of the single business tax*, 22 Wayne L R 1017, 1026-1027 (1976).

[7] Haughey, n 6 *supra*, p 1018.

[8] See Haughey, n 6 *supra*, pp 1018-1019; Special Report, *Evaluation of an additive-method value-added tax for use in the United States*, 30 Tax Lawyer 565, 566 (1977).

[9] See Kasischke, *Computation of the Michigan single business tax: Theory and mechanics*, 22 Wayne L R 1069 (1976); United States Advisory Commission on Intergovernmental Relations, *The Michigan single business tax: A different approach to state business taxation* (1978).

Under the act, "tax base" is defined as business income (or loss) before apportionment subject to certain adjustments. MCL 208.9; MSA 7.558(9). "Business income" is essentially federal taxable income. MCL 208.3(3); MSA 7.558(3)(3). Common adjustments to business income include additions to reflect the business consumption of labor and capital. Those include adding back compensation, depreciation, dividends, and interest *paid* by the taxpayer to the extent deducted from federal taxable income. Common deductions from business income include dividends, interest, and royalties *received* by the taxpayer to the extent included in federal taxable income.[10] This income is deducted for the purpose of value added computation because it does not result from capital expenditure by the taxpayer. Kasischke, *Computation of the Michigan single business tax: Theory and mechanics*, 22 Wayne L R 1069, 1081 (1976).

Once the taxpayer's tax is determined, it must then be allocated to the state where the business activity of the taxpayer can be fairly attributed. "As a general principle, a State may not tax value earned outside its

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[10] In the instant case, Trinova's tax base for 1980 was $221,125,319 computed as follows:

1.	business income (loss)	$(42,466,114)
2.	add: compensation	226,356,271
	depreciation	23,262,909
	dividends, interest, royalties paid	22,908,950
	other	549,526
3.	subtotal	230,611,542
4.	deduct: dividends, interest, and royalties received	9,486,223
5.	Section 9 tax base	$221,125,319

borders." *ASARCO, Inc v Idaho State Tax Comm*, 458 US 307, 315; 102 S Ct 3103; 73 L Ed 2d 787 (1982). For example, if a business conducts its business activity exclusively in Michigan, its entire § 9 tax base would be allocated to Michigan and subject to taxation under the act. MCL 208.40; MSA 7.558(40). If, however, the taxpayer's business activity was only partially attributable to Michigan, only a portion of that activity may constitutionally be taxed. Consequently, the act provides a formula for apportioning a taxpayer's tax base between two or more taxing states. MCL 208.45; MSA 7.558(45). The apportionment formula is an average computed as follows:

1. $\frac{\text{value of taxpayer's Michigan property}}{\text{average value of taxpayer's total property}} = X$
2. $\frac{\text{total wages paid in Michigan}}{\text{total wages paid by the taxpayer}} = Y$ [11]
3. $\frac{\text{sales within Michigan}}{\text{total sales}} = Z$
4. $\frac{X+Y+Z}{3} =$ § 45 apportionment percentage [12]
5. Section 9 tax base × § 45 apportionment % = taxpayer's apportioned tax base subject to tax.

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[11] Wages differ from compensation under the act. In MCL 208.49; MSA 7.558(49), the definition of "wages" is taken from § 3401 of the Internal Revenue Code and includes, with certain exceptions, any "remuneration . . . for services performed by an employee for his employer . . . ." 26 USC 3401(a). Recall that "compensation" is made up of wages together with payments for such things as unemployment compensation, FICA taxes, workers' compensation, etc. Thus, "wages" is not synonymous with "compensation."

[12] This formula is patterned after § 18 of the Uniform Division of Income for Tax Purposes Act. 7A ULA 355. See also anno: *Construction and application of uniform division of income for tax purposes act*, 8 ALR4th 934; Pierce, *The uniform division of income for state tax purposes*, 35 Taxes 747 (1957).

In this case, the value of Trinova's apportioned property equaled .0930 (X = .0930), its apportioned compensation equaled .2328 (Y = .2328), and its apportioned sales equaled 26.5892 (Z = 26.5892). Thus, $\frac{X+Y+Z}{3} = 8.9717$. Trinova's adjusted tax base is therefore its tax base (221,125,319) multiplied by the apportionment percentage (8.9717), equaling $19,838,700.

Once apportioned, the tax base is then subject to certain adjustments which are not significant for the purpose of this description. The taxpayer, under limited circumstances, also may elect to reduce its apportioned tax base as provided under § 31 to compensate for high labor compensation costs [13] or if its tax base is large in relation to its gross receipts. MCL 208.31(2), (5); MSA 7.558(31)(2), (5).[14] Once apportioned and adjusted, the tax base is then multiplied by 2.35 percent to determine the taxpayer's tax liability. MCL 208.31(1); MSA 7.558(31)(1).

At the heart of this dispute is an additional provision applicable when the taxpayer demonstrates that the apportionment formula provided in § 45 does not fairly represent the extent of its business activity in the state. MCL 208.69; MSA 7.558(69), prior to 1987 PA 39, provided:

> (1) If the apportionment provisions of this act do not fairly represent the extent of the taxpayer's

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[13] For example, under MCL 208.31(5); MSA 7.558(31)(5), Trinova was permitted to reduce its adjusted tax base by the percentage that its compensation divided by its unadjusted tax base exceeded sixty-three percent, such reduction not to exceed thirty-seven percent. Trinova's compensation ($226,356,271) divided by its tax base ($221,125,319) equaled 102 percent. Thus, Trinova was entitled to further reduce its adjusted tax base ($19,829,637) by thirty-seven percent or $7,336,966, resulting in a final adjusted tax base subject to tax of $12,492,671.

Pursuant to 1987 PA 39, the definition of "adjusted tax base" now includes the adjustments provided in § 31. Thus, Trinova's "adjusted tax base" is $12,492,671 rather than $19,829,637.

[14] See Kasischke, *supra*, pp 1091-1093.

business activity in this state, the taxpayer may petition for or the commissioner may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) Separate accounting.

(b) The exclusion of any 1 or more of the factors.

(c) The inclusion of 1 or more additional factors which will fairly represent the taxpayer's business activity in this state.

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.

(2) An alternate method will be effective only if it is approved by the commissioner.

At issue in this case is whether the Court of Appeals properly rejected Trinova's request for § 69 relief.

III

STATUTORY ANALYSIS

We are first asked to consider the propriety of the Court of Appeals ruling in *Jones & Laughlin Steel Corp, supra*, which was relied upon by the Court of Claims and rejected by the Court of Appeals in the instant case.[15] In that case, Jones & Laughlin challenged its tax base apportionment as derived under the statutory three-factor formula for the tax years 1976, 1977, and 1978. For those years the three-factor formula resulted in the apportionment of compensation expense to Michigan which exceeded the taxpayer's actual compensation expense by

[15] The *Jones & Laughlin* case was a consolidation of a similar dispute involving Wilson Foods Corporation. For the purpose of this discussion we refer only to the claims of Jones & Laughlin.

an average of sixty- two percent.[16] Further, the compensation component comprised between eighty-five and ninety-four percent of Jones & Laughlin's adjusted tax base. On the basis of this information, Jones & Laughlin successfully argued that the statutory apportionment formula failed to fairly reflect its Michigan business activity and also gained approval of an alternate apportionment formula which is similar to that used by Trinova in the case at bar.

The apportionment method approved by the *Jones & Laughlin* Court applied the statutory three-factor formula to the taxpayer's § 9 tax base exclusive of the adjustment for compensation. To this figure the taxpayer's actual Michigan compensation was allocated. The sum of these two figures was then multiplied by the statutory rate to determine the single business tax liability. The Court found this method preferable because it employed the taxpayer's actual compensation figure rather than an approximated amount which "excessively attributed compensation to Michigan." *Jones & Laughlin, supra*, p 413. The Court specifically rejected the state's claim that § 69 relief was warranted only if the apportionment formula resulted in an unfair tax liability. Rather, the Court ruled that when any element of the taxpayer's business activity as reflected in its tax base is shown to be inaccurately represented, § 69 relief is available.

We reject the *Jones & Laughlin* rule because it effectively negates those sections of the act specifying the method for calculating apportioned tax base and thereby converts § 69 into an all-purpose tax equity provision. We believe that the error of the *Jones & Laughlin* Court may be traced to an incorrect understanding of the concept of fair apportionment.

[16] Jones & Laughlin's compensation figures for the disputed tax years provided:

Year	Michigan Comp	Apportioned Comp	% over Actual
1976	26,385,639	39,902,544	51.2
1977	21,629,704	38,662,908	78.7
1978	21,782,621	33,739,117	54.9

A

The Legislature has determined that § 69 apportionment relief may be obtained "[i]f the apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state . . . ." Our first task is to determine what is meant by "fairly represent" as it relates to the proper operation of the statutory apportionment formula. Obviously, from the taxpayer's perspective, fair business activity representation is that which results in the lowest possible apportioned tax base and resulting tax liability. From the viewpoint of the state, fair representation translates into accountability for every activity of the taxpayer which under the law may be taxed by this state. While the result might be the same under either approach, in practice they are not compatible viewpoints. Consequently, unless the concept of fairness is rooted in something other than the conflicting values of the state and taxpayer or vague notions of equity, it is useless as a demarcation of entitlement to relief.

We therefore begin with the unchallenged premise that a fair representation of business activity in this case must be directed to the purpose of apportionment. The central purpose of any apportionment scheme is to "ensure that each State taxes only its fair share of an interstate transaction." *Goldberg v Sweet*, 488 US ——: 109 S Ct 582, 588; 102 L Ed 2d 607 (1989). Thus, a fair representation of business activity is one which ensures that each state taxes only its share of interstate transactions. With that central function in mind, it becomes obvious that § 69 functions essentially as a constitutional "circuit breaker."

Taxation of the intrastate activity of an interstate enterprise presents the potential for Due Process and Commerce Clause violations.[17] To preserve the constitution-

[17] A state tax when applied to interstate commerce will be sustained under Commerce Clause analysis "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto Transit, Inc v Brady*, 430 US 274, 279; 97 S Ct 1076; 51 L Ed 2d 326 (1977). See also *Amerada Hess Corp v New Jersey Dep't of the Treasury*, 490 US ——; 109 S Ct 1617; 104 L Ed 2d 58 (1989).

For a state to tax income generated in interstate commerce, the Due Process Clause of the Fourteenth Amendment imposes two requirements: "a 'minimal connection' between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Mobil Oil Corp v Comm'r of Taxes of Vermont*, 445 US 425, 436-437; 100 S Ct 1223; 63 L Ed 2d 510 (1980).

[18] A "unitary business" has been defined "as a single business conducted both within and without the taxing state and whose tax base cannot be satisfactorily identified on a geographical basis." Hellerstein, *State income taxation of multijurisdictional corporations: Reflections on Mobil, Exxon, and H. R. 5076*, 79 Mich L R 113, 122, n 50 (1980). Appellant does not contest the fact that it is a "unitary business" for the purpose of apportionment and taxation under the act.

ality of the act, § 69 allows the use of an alternate method of apportionment if the apportionment provisions result in the unconstitutional taxation of a unitary business.[18] In other words, we believe that § 69 applies only in the most unusual of circumstances—when the statutory method operates unconstitutionally to tax the extraterritorial activity of the taxpayer. While admittedly the taxpayer gains from the operation of § 69 by a reduction of its apportioned tax base, the primary role of § 69 is to safeguard the act and not to shelter the taxpayer. Only when read in light of this basic constitutional foundation does "fairness" as a guiding principle serve the function of objective measure. Consequently, we turn to established constitutional doctrine to ascertain the guideposts of "fairness" in our review of the act's formulary apportionment scheme.

B

As a general rule, a state may not "tax value earned outside its borders." *ASARCO, Inc, supra, p 315. "In the case of a more-or-less integrated business enterprise operating in more than one state, however, arriving at precise territorial allocations of 'value' is often an elusive goal, both in theory and in practice." Container Corp v Franchise Tax Bd*, 463 US 159, 164; 103 S Ct 2933; 77 L Ed 2d 545 (1983). Because of the nebulous nature of value or, in this case, business activity, and the difficulty confronted when attempting to identify purely intrastate value, the United States Supreme Court has refused to require the use of one formula to the exclusion of all others. *Id.; Goldberg v Sweet, supra*, 109 S Ct 588. "Such an apportionment formula must, under both the Due Process and Commerce Clauses, be fair." *Container Corp, supra*, p 169. See also *Shell Oil Co v. Iowa Dep't of Revenue*, 488 US ——; 109 S Ct 278; 102 L Ed 2d 186, 199 (1988) (the function of an apportionment formula is to determine the portion of a unitary business' income that can be "fairly" attributed to in-state activities).

The first component of fairness in an apportionment formula has been termed "internal consistency." *Id.*[19] To be internally consistent, a formula must result in no more than one-hundred percent of the taxpayer's business activity being taxed if all taxing jurisdictions employed the same formula. In this case, the apportionment provisions of the single business tax are internally consistent because no multiple taxation would result if every state were to adopt the act. The business activity of any unitary business would be apportioned by each taxing jurisdiction using the identical method. Trinova does not con-

[19] See, generally, Hellerstein, *Is "internal consistency" foolish: Reflections on an emerging Commerce Clause restraint on state taxation*, 87 Mich L R 138 (1988).

test the internal consistency of the act's apportionment formula.

The second component of a fair apportionment formula is "external consistency." External consistency requires that the choice of factors used in the formula "must actually reflect a reasonable sense of how [the business activity] is generated." *Id.; Goldberg v Sweet, supra*, 109 S Ct 589. The constitution does not require an exact apportionment, and an apportionment formula will not be judged to be unfair if "it *may* result in taxation of some [business activity] that did not have its source in the taxing State . . . ." *Moorman Mfg Co v Bair*, 437 US 267, 272; 98 S Ct 2340; 57 L Ed 2d 197 (1978). An apportionment formula will be struck as being externally inconsistent only upon a showing by the taxpayer of "clear and cogent evidence" that the business activity attributed to the state is "out of all appropriate proportions" to the business transacted in that state, or "has led to a grossly distorted result." *Moorman Mfg Co, supra*, p 274; *Norfolk & Western R Co v Missouri State Tax Comm*, 390 US 317, 326; 88 S Ct 995; 19 L Ed 2d 1201 (1968).[20]

In *Jones & Laughlin*, the Court of Appeals ignored these principles of fair apportionment. Rather, it found the statutory apportionment formula to unfairly represent the extent of the taxpayer's intrastate business ac-

[20] Although our opinion is not based upon this observation, we find it instructive that the amended § 69 now provides in relevant part:

> The apportionment provisions of this act shall fairly represent the business activity attributed to the taxpayer in this state, taken as a whole and without a separate examination of the specific elements of the tax base such as depreciation, compensation, or income, unless it can be demonstrated that the business activity attributed to the taxpayer in this state is out of all appropriate proportion to the actual business transacted in this state and leads to a grossly distorted result. [MCL 208.69(3); MSA 7.558(69)(3), as amended by 1987 PA 39.]

tivity because compensation, as reflected in the § 9 tax base, was "over-apportioned or excessively attributed" to Michigan. *Jones & Laughlin, supra*, p 413. We cannot agree with this conclusion.[21]

First, while we agree with the *Jones & Laughlin* Court that the test for fairness is not whether the taxpayer's final tax liability is reasonable when weighed against its intrastate business activity, we disagree with the standard adopted by that Court. The Court of Appeals determined that the statutory formula yielded an unfair apportionment because 1) eighty-five to one hundred percent of the taxpayers' adjusted tax bases consisted of compensation; 2) use of the three-factor formula overstated compensation more than fifty percent; and 3) the taxpayers' actual Michigan compensation could be precisely calculated. On these facts, the Court held that the taxpayers had "presented clear and convincing evidence 'that the statutory formula inadequately or inaccurately represent[ed] [their] unitary business activity in the taxing state.'" *Jones & Laughlin, supra*, p 413, quoting, *Dono-*

[21] Arguably, the taxpayer's true dispute in *Jones & Laughlin* was not with the apportionment formula, but, rather, with the computation of the § 9 tax base. Indeed, the taxpayers alternate formula in that case simply applied the statutory formula to its § 9 tax base exclusive of the compensation adjustment and allocated the exact amount of its Michigan compensation to the apportioned figure.

Indeed, in its reply brief, Trinova admits that it questions the constitutionality of the § 9 tax base computation and claims that § 69 after *Jones & Laughlin* "cure[d] the flaws in the method by which Section 9 establishes the tax base." Trinova is mistaken as to the proper function of § 69. Its purpose is to provide relief when the statutory apportionment provisions result in the unconstitutional taxation of a unitary business. Section 69 was not intended to shelter the taxpayer from rightful tax liability and should not be read to provide apportionment relief anytime a taxpayer can show, by manipulating its tax base, that a lower tax liability can be achieved. When read in this manner, § 69, which was intended by the Legislature to be the rule of exception, becomes instead the rule of general application.

van v Dep't of Treasury, 126 Mich App 11, 21; 337 NW2d 297 (1983). As noted, however, the test for fair apportionment is not whether a formula results in inadequate or even inaccurate apportionment. The test is whether the use of a particular method of apportionment results in business activity being attributed to this state which is "out of all appropriate proportions" to the taxpayer's intrastate business activity, or has "led to a grossly distorted result."[22]

As explained earlier, "fairness" in the context of multistate tax or tax base apportionment must be considered under Due Process and Commerce Clause analysis. The opinion of the Court of Appeals in *Jones & Laughlin* is wholly lacking in consideration of internal consistency. Even assuming that the Court's analysis was directed towards the concerns of external consistency, we do not believe that identifying a fifty-percent overstatement of compensation, which is but one element of the taxpayer's intrastate business activity, demonstrates by "clear and cogent evidence" that the business activity attributed to this state was "out of all appropriate proportion" to the business transacted in the state, or has led "to a grossly distorted result."

As a precondition to § 69 relief, a showing must be made that the taxpayer's business activity within this state is unfairly represented. Under the Single Business Tax Act, "business activity" is defined as encompassing any transfer of property, performance of services, or a combination thereof "with the object of gain, benefit, or

[22] We recognize that a juxtaposition of this language with that of § 69 suggests a teleological gulf. However, had the legislation utilized this precise language, the statute would be left inflexibly tied to the language of the most recent position of the United States Supreme Court without regard to subsequent changes. Flexibility, which we believe to be the essential purpose of § 69, requires the more general language of "fairly represent." Unfortunately, it appears that *Jones & Laughlin* has forced the Legislature's hand in amending the code. See n 20, p 158.

advantage." MCL 208.3(2); MSA 7.588(3)(2).[23] The subject of the act thus encompasses the complete range of entrepreneurial activities of which compensating employees is but one part. Consequently, to conclude that a taxpayer's business activity is not fairly apportioned because a single component of that activity, when examined by geographical accounting, is not accurately reflected under the statutory apportionment scheme belies the very definition of business activity. "The problem with this method is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." *Container Corp, supra*, pp 164-165.

Obviously, compensation will be a substantial portion of the tax base in most businesses. Nonetheless, we cannot ignore the integrated nature of formulary apportionment which rejects separate accounting as a means to identify business activity by reference to a discrete geographic boundary. As the United States Supreme Court has observed, it is "precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place." *Con-*

[23] MCL 208.3(2); MSA 7.558(3)(2) provides:

> "Business activity" means a transfer of legal or equitable title to or rental of property, whether real, personal, or mixed, tangible or intangible, or the performance of services, or a combination thereof, made or engaged in, or caused to be made or engaged in, within this state, whether in intrastate, interstate, or foreign commerce, with the object of gain, benefit, or advantage, whether direct or indirect, to the taxpayer or to others, but shall not include the services rendered by an employee to his employer, services as a director of a corporation, or a casual transaction. Although an activity of a taxpayer may be incidental to another or other of his business activities, each activity shall be considered to be business engaged in within the meaning of this act.

tainer Corp, supra, p 181.[24] Further, while admittedly the three- factor formula is not perfect, and its application in a value added tax scheme is relatively unique, the constitution requires neither a perfect formula nor a perfect apportionment. The United States Supreme Court long ago upheld the constitutionality of formulary apportionment. See, e.g., *Hans Rees' Sons, Inc v North Carolina*, 283 US 123; 51 S Ct 385; 75 L Ed 879 (1931). Further, the Court has specifically found that property, payroll, and sales may be appropriate ingredients of an apportionment formula, *Butler Bros v McColgan*, 315 US 501, 509; 62 S Ct 701; 86 L Ed 991 (1942). Indeed, the three-factor formula is viewed as "something of a benchmark against which other apportionment formulas are judged." *Container Corp, supra*, p 170. See also *Amerada Hess Corp v New Jersey Dep't of the Treasury*, 490 US ——; 109 S Ct 1617; 104 L Ed 2d 58 (1989).

In short, while we recognize that certain components of the taxpayer's business activity are subject to accurate geographic attribution, we do not believe that "business activity" as defined under the act is susceptible to accurate analysis when only one component of the total business effort is examined. To properly judge the propriety of a taxpayer's apportioned business activity, we must view the activity as a whole.

[24] In *Mobil Oil Corp v Comm'r of Taxes of Vermont*, n 17 *supra*, p 438, the United States Supreme Court aptly noted the failings of separate accounting:

> [S]eparate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required. [Citations omitted.]

IV

THE APPLICATION OF § 69 TO TRINOVA

In the present case, Trinova sought § 69 apportionment relief on the ground that its apportioned 1980 compensation was approximately forty times greater than its actual Michigan compensation, and that its apportioned depreciation was approximately one thousand times greater than its actual Michigan depreciation. On the basis of these two facts, Trinova persuaded the Court of Claims that the *Jones & Laughlin* rule entitled it to relief because the act's apportionment formula failed to accurately represent its Michigan business activity. We do not believe that these two facts show by "clear and cogent evidence" that the statutory apportionment provisions attributed business activity to Michigan which was "out of all appropriate proportion" to Trinova's actual business transacted in Michigan, or "has led to a grossly distorted result."

As calculated under § 45, the apportionment formula resulted in an apportionment percentage of 8.9717. More specifically, of Trinova's § 9 tax base of $221,125,319, approximately nine percent was apportioned to Michigan resulting in an apportioned tax base of $19,838,700. We simply cannot conclude as a matter of law that this amount is out of all appropriate proportion to Trinova's Michigan business activity or results in a grossly distorted apportionment figure. Trinova's actual Michigan compensation was $511,774, and its actual property as reflected in its depreciation expense was $2,152. While these figures obviously represent a very small percentage of Trinova's total business activity, they are offset by its Michigan sales figure of $103,981,354.[25] When viewed as

[25] Sales of goods are considered in this state if "[t]he property is shipped or delivered to a purchaser, other than the United States government, within this state regardless of the free on board point or other conditions of the sale." MCL 208.52(a); MSA 7.558(52)(a). Under MCL 208.3; MSA 7.558(3), "business activity" includes the transfer of legal title to property in this state with the object of gain, benefit, or advantage. Thus, under the act, Trinova's sales to Michigan purchasers clearly were "business activity."

a whole, we believe the averaged ratios of Trinova's payroll, property, and sales "actually reflect a reasonable sense of how [its Michigan business activity was] generated," clearly satisfying the constitutional requirements of internal and external consistency.

We emphasize that § 69 was not intended as an all-purpose tax equity provision. However, assuming arguendo that the Legislature intended § 69 as a tax equity provision, we would nevertheless reject Trinova's petition [26] for relief. Our reading of MCL 208.68(1); MSA

[26] Although the matter is not addressed by the parties to this appeal, we believe that the *Jones & Laughlin* Court also erred procedurally. In *Jones & Laughlin*, the Tax Tribunal's grant of relief was affirmed despite the taxpayer's failure to "petition" the commissioner for relief as required by § 69(1) or obtain approval for the alternate formula as required by § 69(2). In our view, § 69(1) clearly requires that a taxpayer petition for relief before an alternate apportionment formula will be considered. Further, § 69(2) specifically mandates that "[a]n alternate method will be effective only if it is approved by the commissioner." MCL 208.69(2); MSA 7.558(69)(2). It is undisputed that the taxpayers in *Jones & Laughlin* neither petitioned for, nor obtained commissioner approval of the apportionment formula ultimately used. The Tax Tribunal excused this requirement in *Jones & Laughlin* because of a lack of procedural rules for the evaluation of an alternate formula. We cannot so easily disregard the express language of §§ 69(1) and 69(2).

The petition requirement of § 69(1) and the prior approval requirement of § 69(2) are in no way dependent upon the adoption of formal procedural rules for the evaluation of an alternate apportionment formula. We cannot condone a ruling which permits clear legislation to be ignored. In short, the Court of Appeals in *Jones & Laughlin* failed to properly determine the fairness of the statutory apportionment formula under accepted constitutional measures and further failed to enforce the express procedural

7.558(68)(1) indicates that certain businesses which do not own or rent real estate or tangible personal property in Michigan and which do not have gross sales in Michigan in excess of $100,000 may use an apportioned tax base consisting only of sales. Thus, it is clear that the Legislature was aware that business activity heavily weighted toward sales might better be taxed upon a different base. However, the Legislature provided relief in only the more extreme cases. The apportionment formula proposed by Trinova under § 69 [27] uses a tax base identical to that provided in § 68, yet Trinova does not meet any of the qualifying criteria imposed by the Legislature. We find it most difficult to believe that the Legislature intended to provide relief under the general provision of § 69 which it expressly precluded under the more specific § 68. See, generally, 2A Sands, Sutherland Statutory Construction (4th ed), § 51.05, pp 499-500. It is indeed the careful and specific drafting of the Single Business Tax Act which leads us to the conclusion that the Legislature saw no need for an all-purpose tax equity provision.

In passing, we also note that the sales at issue were not "at retail," MCL 205.51; MSA 7.521, and therefore do not fall within Michigan's General Sales Tax Act, MCL 205.52; MSA 7.522. Therefore, if Trinova's construction of the Single Business Tax Act is correct, $103,981,354 in sales will be entirely untaxed. Considering the two acts in pari materia, *County Rd Ass'n of Michigan v Bd of State Canvassers*, 407 Mich 101, 118-119; 282 NW2d 774 (1979),[28] we believe that this result

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requirement of §§ 69(1) and 69(2) before approving the taxpayers' requests for apportionment relief. This is clarified in the amended § 69(4). In remanding this matter, we do not preclude the defendant from raising this issue in the Court of Claims.

[27] See n 4.

[28] As explained in 2A Sands, Sutherland Statutory Construction (4th ed), § 51.03, p 468, the guiding principle for whether statutes

was not within the intentions of the Legislature in enacting the single business tax. Again, we observe the express legislative intent that the "tax so levied and imposed is upon the privilege of doing business . . . ." MCL 208.31(4); MSA 7.558(31)(4).

While we do not adopt all of the reasoning of the Court of Appeals in this case, we agree with its conclusion that Trinova has failed to demonstrate an entitlement to tax-base relief under § 69. To the extent that the decision in *Jones & Laughlin* is inconsistent with this opinion, it is overruled. [29]

CONCLUSION

We hold that § 69 apportionment relief may obtain upon a showing by the challenging party of clear and cogent evidence that the total business activity attributed to the state is out of all appropriate proportion to the taxpayer's intrastate business activity or has led to a grossly distorted result. Here, the challenging party, Trinova, has failed to show that its total business activity attributed to Michigan is out of all appropriate proportion to the taxpayers intrastate business or has led to a grossly distorted result.

We therefore affirm that aspect of the Court of Appeals decision reversing the decision of the Court of

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are in pari materia is whether it is natural and reasonable to think that the understanding of members of the Legislature would be influenced by the other statute. In our view, it is natural and reasonable to think that the Legislature considered the scope of the General Sales Tax Act in drafting the Single Business Tax Act.

[29] We also are asked to decide whether 1987 PA 39 was intended by the Legislature to apply retroactively to tax years prior to 1987, and, if so, whether that enactment is constitutional. The Attorney General argues that even if *Jones & Laughlin* correctly construed the act prior to amendment, 1987 PA 39 must be applied retroactively to defeat Trinova's claim. Trinova itself seeks no relief under the amendment. Therefore, in light of our rejection of the rule of *Jones & Laughlin* and Trinova's claim for apportionment relief, we find it unnecessary to reach these remaining two issues.

Claims. This matter is remanded to the Court of Claims for further proceedings consistent with this opinion.

RILEY, C.J., and BRICKLEY, CAVANAGH, ARCHER, and GRIFFIN, JJ., concurred with BOYLE, J.

LEVIN, J. (*separate opinion*). I would remand this cause for a hearing, together with the several hundred other cases pending in the Court of Claims, on the factual issues adverted to in the briefs of the parties and the amici curiae and in the opinion of the Court. See *Commonwealth Edison Co v Montana*, 453 US 609, 638; 101 S Ct 2946; 69 L Ed 2d 884 (1981) (Blackmun, J., dissenting).

Michigan Supreme Court
Lansing, Michigan

Order

Entered: October 16, 1989

Rehearing No. 223

SC 82673
CoA 100641
LC 86-10430-CM

TRINOVA CORPORATION (formerly
LIBBEY-OWENS-FORD COMPANY),
Plaintiff-Appellant,

v

STATE OF MICHIGAN, DEPARTMENT OF TREASURY,
REVENUE DIVISION,
Defendant-Appellee.

In this cause, a motion for rehearing, is considered and, on order of the Court, it is hereby DENIED.

I, CORBIN R. DAVIS, Clerk of the Michigan Supreme Court, certify that the foregoing is a true and complete copy of the order entered at the direction of Court.

[SEAL]

October 16, 1989

s/ Jacqueline B. MacKinnon
Deputy Clerk

MICHIGAN COURT OF APPEALS

Docket No. 100641

TRINOVA CORPORATION

v.

DEPARTMENT OF TREASURY

Submitted February 11, 1988, at Lansing
Decided February 22, 1988
Leave to appeal granted, 430 Mich —.

Trinova Corporation, an Ohio corporation licensed to do business in Michigan, brought an action against the Michigan Department of Treasury in the Court of Claims, seeking to recover $293,528 which it allegedly overpaid on its single business tax in 1980. Trinova claimed that the statutorily mandated three-factor average percentage used to determine the corporation's Michigan business activity when applied to the compensation and property factors resulted in compensation and property figures which were well in excess of the actual figures and that, on the basis of the holding in *Jones & Laughlin Steel Corp v Dep't of Treasury*, 145 Mich App 405 (1985), it was entitled to an alternative method of apportionment which would result in the claimed tax saving. The Department of Treasury argued that Trinova was not entitled to use an alternative metnod of apportionment and that Trinova owed additional taxes for 1980 on the basis of an alternative one-factor formula the department proposed. Both Trinova and the department moved for summary disposition. The Court of Claims, Robert Holmes Bell, J., granted Trinova's motion for summary disposition, adopted the reasoning of *Jones & Laughlin* and held that, as a matter of law, the statutory apportionment formula failed to accurately reflect Trinova's Michigan business activity. The department appealed.

The Court of Appeals *held:*

1. The holding in *Jones & Laughlin* is rejected, since the *Jones & Laughlin* opinion fails to take into account that, to the extent that the statutorily computed average figure would overevaluate one or two of the three factors making up the average, it would have the effect of underevaluating the remaining factor or factors. The Legislature's 1987 legislative response to the *Jones & Laughlin* decision clearly evidences that it was always the intent of the Legislature that the alternative method of apportionment provision was to be available only where application of the apportionment figure calculated from the statutory formula would result in an unfair representation of the taxpayer's Michigan business activity taken as a whole.

2. Since the 1987 amendment by the Legislature was to clarify its original intent in the face of a judicial pronouncement which was contrary to the Legislature's original intent, it is proper to give retrospective application to the provisions of the 1987 amendment.

Reversed and remanded.

1. TAXATION—SINGLE BUSINESS TAX—APPORTIONMENT OF TAX BASE—ALTERNATIVE METHODS OF APPORTIONMENT.

Relief from application of the three-factor apportionment formula of the Single Business Tax Act was available under the provision allowing exemption from the

allocation provision under certain circumstances prior to the 1987 amendment of that provision only where application of the apportionment formula resulted in an unfair representation of the taxpayer's Michigan business activity taken as a whole; relief under that section was not available merely because the calculated average failed to accurately reflect one or two of the three factors where final allocation resulting from the statutorily calculated figure fairly represented the Michigan business activity taken as a whole (MCL 208.69; MSA 7.558[69]).

2. TAXATION—SINGLE BUSINESS TAX—APPORTIONMENT OF TAX BASE—AMENDMENT OF STATUTES—LEGISLATIVE INTENT—RETROACTIVITY.

The Legislature clearly intended the 1987 amendment of the provision of the Single Business Tax Act permitting alternative methods of apportionment of tax base under certain circumstances to have retroactive effect; since it is clear that the 1987 amendment was a response to a decision of the Court of Appeals and evidenced a clear expression by the Legislature that the amendment was an attempt to more certainly express the Legislature's original intent, the amendatory section should be retrospectively applied to the date of the original statute (1987 PA 39; MCL 208.69; MSA 7.558[69]).

Dickinson, Wright, Moon, Van Dusen & Freeman (by *Ernest Getz and Elizabeth Trickey*), for plaintiff.

Frank J. Kelley, Attorney General, *Louis J. Caruso*, Solicitor General, and *Richard R. Roesch* and *Charles E. Liken*, Assistant Attorneys General, for defendant.

Amicus Curiae:

Clark, Klein & Beaumont (by *David H. Vincent, J. Walker Henry, Curtis J. Mann* and *Joseph A. Bonventre*), and *Thomas J. Hughes* and *E. Alan Moorhouse*, of Counsel, for Michigan Manufacturers Association.

Before: R.M. MAHER, P.J., and SHEPHERD and K. TERTZAG,* JJ.

PER CURIAM. The appeal involves the method by which plaintiff, Trinova Corporation, is to apportion its adjusted tax base to reflect its Michigan business activity for the year 1980 pursuant to the Single Business Tax Act, MCL 208.1 *et seq.*; MSA 7.558(1) *et seq.* Trinova, an Ohio corporation licensed to do business in Michigan, manufactures automobile parts which it sells throughout the United States, including Michigan. In 1980, Trinova had an office here and employed fourteen persons who solicited orders for Trinova's glass division and provided liaison with its Michigan customers. Trinova's 1980 sales in the state totaled $103,981,354, more than one-fourth of its total sales.

The Single Business Tax Act (SBTA) imposes a specific tax on what is known as the "adjusted tax base" of every person, such as Trinova, with business activity in Michigan which is allocated or apportioned to Michigan. *Town & Country Dodge, Inc v Dep't of Treasury*, 420 Mich 226, 234-235; 362 NW2d 618 (1984), reh den 421 Mich 1202 (1985); MCL 208.31(1); MSA 7.558(31)(1). As was held by this Court in *Wismer & Becker Contracting Engineers v Dep't of Treasury*, 146 Mich App 690, 696; 382 NW2d 505 (1985):

> The Single Business Tax is a tax upon the privilege of doing business and not upon income. It "is best understood as a value added tax, although it is not a pure value added tax." *Town & Country Dodge, Inc v Dep't of Treasury*, 420 Mich 226, 234; 362 NW2d 618 (1984). A value added tax taxes economic activity itself, unlike an income tax, which taxes what has been received from the economy at a later time when it become "income." *Mobile Oil Corp v Dep't of Treasury*, 422 Mich 473; 373 NW2d

* Circuit judge, sitting on the Court of Appeals by assignment.

730 (1985). In theory, the income tax and the value added tax impose a tax on the same things, but at different stages of the economic process, and should generate the same amount of revenue, even though collected from different sources. See *Mobil Oil Corp, supra.*

The adjusted tax base to which the single business tax applies consists of federal taxable income subject to certain additions and subtractions contained in § 9 of the act. MCL 208.9; MSA 7.558(9).

Since Trinova has taxable activities both within and outside Michigan, it is liable for an apportioned single business tax pursuant to MCL 208.41; MSA 7.558(41). The apportionment is arrived at by applying a three-factor formula to the adjusted tax base:

> All of the tax base, other than the tax base derived principally from transportation, financial, or insurance carrier services or specifically allocated, shall be apportioned to this state by multiplying the tax base by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3. [MCL 208.45; MSA 7.558(45).][1]

The purpose of this formula is to determine that proportion of a taxpayer's business activity which is attributable to its Michigan-based operations. In the instant case, the property factor was .0930 percent, the payroll factor was .2328 percent, and the sales factor was 26.5892 per-

[1] The apportionment formula is calculated by averaging the percentages of Trinova's property, payroll and sales attributable to its Michigan operation. Algebraically, that formula is:

$$\frac{\frac{\text{MICHIGAN PROPERTY}}{\text{TOTAL PROPERTY}} + \frac{\text{MICHIGAN PAYROLL}}{\text{TOTAL PAYROLL}} + \frac{\text{MICHIGAN SALES}}{\text{TOTAL SALES}}}{3}$$

cent. The average of those factors was 8.9717 percent.[2] This was the percentage which was applied to Trinova's adjusted tax base in order to arrive at its Michigan tax base.

In 1986, Trinova filed suit against the Department of Treasury in the Court of Claims, seeking to recover $293,528 in single business tax overpaid for the year 1980. It contended that the apportionment formula provisions of the SBTA did not fairly reflect Trivona's business activity in Michigan because, as applied, the formula resulted in an apportioned tax base in which taxed value was not rationally related to business conducted in Michigan. In support, Trinova asserted that its apportioned compensation under the formula was thirty-eight times greater than its actual compensation expenses attributable to Michigan and its apportioned depreciation (i.e., property) was 960 times greater than its actual Michigan depreciation expenses. Trinova sought relief pursuant to MCL 208.69; MSA 7.558(69) which, at the time the suit was filed, provided in relevant part:

> (1) If the apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commissioner may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> * * * *
>
> (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.

[2] We must emphasize that the average factor of 8.9717 percent, is just that, an average. The effect of the higher sales percentage is offset by the smaller property and payroll factors, and vice versa. For a more in-depth explanation of the formula's rationale, see *Wismer & Becker Contracting Engineers, supra,* pp 698-702.

The department answered and counterclaimed, asserting that Trinova was not entitled to § 69 relief and, in fact, owed additional taxes for 1980 on the basis of an alternate one-factor formula it proposed. Each side filed a motion for summary disposition.

On May 5, 1987, the Court of Claims issued its opinion and order granting Trinova's motion for summary disposition and directing the department to refund to Trinova any overpayment and interest to which it was entitled.[3]

In claiming its refund, Trinova used a two-step apportionment/allocation method based on a method approved in *Jones & Laughlin Steel Corp v Dep't of Treasury*, 145 Mich App 405; 377 NW2d 397 (1985), lv den 424 Mich 895 (1986). In *Jones & Laughlin*, this Court approved a two-step method for the two taxpayers involved in that appeal by which each was permitted to apply the statutory three-factor apportionment formula to its adjusted tax base exclusive of the compensation adjustment of MCL 208.9(5); MSA 7.558(9)(5) and then use the actual amount of compensation attributable to Michigan. The Court found this alternate method to be appropriate because "petitioners presented clear and convincing evidence 'that the statutory formula inadequately or inaccurately represent(ed) (their) unitary business in [Michigan].'" 145 Mich App 413 (quoting *Donovan Construction Co v Dep't of Treasury*, 126 Mich App 11, 21, n2; 337 NW2d 297 [1983], lv den 419 Mich 894 [1984]). Thus, pursuant to that holding, and contrary to the dictates of § 9 of the SBTA, Trinova excluded compensation and depreciation from its preapportionment formula to this "adjusted tax base" and added Trinova's actual Michigan compensation and depreciation expenses to the apportionment product.

[3] The court also denied the department's motion for summary disposition and dismissed its counterclaim. The department has not cross-appealed those decisions.

In this case, the Court of Claims stated that it adopted the reasoning of *Jones & Laughlin* and held "as a matter of law based on the pleadings that the [SBTA's] apportionment formula failed to accurately represent [Trinova's] Michigan business activity." The Court of Claims here apparently applied the *Jones & Laughlin* rationale as a per se rule of law for, in interpreting the Court of Appeals decision, it stated:

> The Court of Appeals went on to hold that where even just one element of business activity is shown, by clear and convincing evidence, to be inaccurately represented by application of the apportionment formula, § 69 relief is available.

We take this opportunity to reject the logic of the *Jones & Laughlin* holding. Since the final apportionment percentage is the *average* of the component percentages (i.e., property, payroll and sales), it will always be larger than at least one of the component percentages unless, of course, they are all equal. Under *Jones & Laughlin*, a foreign taxpayer could defeat the tax simply by taking one factor, the percentage of which is smaller than the average, and applying the average to the total dollar value of that factor. This overvaluation is, as previously mentioned (see footnote 2), offset by the underevaluation of the factor or factors in the apportionment formula for which the actual amount of Michigan activity is larger than the amount calculated using the statutory average. The net effect of the apportionment formula is to ascertain that portion of the foreign taxpayer's adjusted tax base attributable to its business activity in this state. The right to § 69 relief was available only where application of the apportionment formula resulted in an unfair representation of the taxpayer's Michigan-based business activity taken as a whole.

The fallacy of Trinova's instant claim is that it focused only on those factors which distorted the average per-

centage in a manner supporting its claim of overevaluation and failed to recognize the offsetting factors inherent in the apportionment formula. Likewise, this was the error in *Jones & Laughlin*.

A little more than a month after the Court of Claims ruled in Trinova's favor, the Legislature, on June 8, 1987, passed 1987 PA 39 which amended § 69 of the SBTA and, by its terms, was ordered to take immediate effect. The amended version of § 69 uses two tests to determine whether the apportionment formula fairly represents a taxpayer's business activity in Michigan.

> The apportionment provisions of this act shall fairly represent the business activity attributed to the taxpayer in this state, taken as a whole and without a separate examination of the specific elements of the tax base such as depreciation, compensation, or income, unless it can be demonstrated that the business activity attributed to the taxpayer in this state is out of all appropriate proportion to the actual business transacted in this state and leads to a grossly distorted result. A taxpayer's business activity shall be presumed to be fairly represented if the adjusted tax base computed without regard to the reduction based upon gross receipts permitted by section 31(2) is not greater than the adjusted tax base computed after application of the reduction based upon gross receipts permitted by section 31(2) or if the adjusted tax base is not greater than the adjusted tax base which would result from an apportioned tax base computed by using the apportionment formula prescribed for a corporate income tax or franchise tax in the taxpayer's business domicile. The taxpayer's business domicile is the state in which the sum of the taxpayer's payroll factor and property factor is greatest. However, if the taxpayer fails to satisfy either of these tests, the taxpayer's business activity shall not be presumed to not be fairly represented. [MCL 208.69(3); MSA 7.558(69)(3).][4]

The department argues that § 69, as amended, is retroactive and that, given the requirements of the amendment, Trinova does not qualify for § 69 relief. Trinova, on the other hand, contends that § 69, as amended, should not be retroactively applied and that retroactive application would be unconstitutional. It also argues that, even under § 69 as amended, Trinova's entitlement to § 69 relief is not altered.

The Legislature enacted the amendment shortly after the Supreme Court denied leave to appeal in *Jones & Laughlin*, *supra*, and after it became apparent that the Court of Claims was applying its interpretation of the *Jones & Laughlin* rationale as a per se rule to other cases involving foreign corporation taxpayers. In amending § 69, the Legislature specifically declared its intention:

> This amendatory act is curative, expressing the original intent of the legislature that the single business tax imposed under the single business tax act, Act No. 228 of the Public Acts of 1975, being sections 208.1 to 208.145 of the Michigan Compiled Laws, is an indivisible value added type of tax and not a combination or series of several smaller taxes and that relief from formulary apportionment should be granted only under extraordinary circumstances. This amendatory act clarifies the existing procedures and standards for granting relief under section 69 of the single business tax act, Act No. 228 of the Public Acts of 1975, being section 208.69 of the Michigan Compiled Laws. [1987 PA 39, § 2.]

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[4] Two additional subsections were added to § 69 by 1987 PA 39. Subsection (4) provides that "the filing of a return or an amended return shall not be considered a petition for purposes of subsection (1)." Subsection (5) provides that "as used in this section, 'adjusted tax base' means that term as defined in section 31."

Clearly, the Legislature intended that 1987 PA 39 have retroactive effect. In *ACCO Industries, Inc v Dep't of Treasury*, 134 Mich App 316, 321-322; 350 NW2d 874 (1984), lv den 421 Mich 857 (1985), this Court declared that "a later statement of legislative intent by the Legislature is binding on this Court." Although the Legislature cannot, through amendment, change the settled meaning of a statute, it can amend a statute to make plain what the legislative intent had been all along from the time of the statute's enactment, if varying interpretations of the statute have created uncertainty. In those circumstances, the amendment has a retroactive effect. *Id.* at 322. This principle of statutory construction, set forth in *Detroit Edison Co v Janosz*, 350 Mich 606, 613-614; 87 NW2d 126 (1957), and reiterated in *Production Credit Ass'n of Lansing v Dep't of Treasury*, 404 Mich 301, 318-319; 273 NW2d 10 (1978), applies where no settled interpretation of the statute has been established and where the amendment was adopted soon after the controversy as to its interpretation arose—such as here. That timing indicates the amendment was a legislative interpretation of the original act rather than a substantial change of it. *Harper v Progressive Casualty Ins Co*, 79 Mich App 764, 768; 263 NW2d 1 (1977); 1A Sutherland, Statutory Construction (4th ed), § 22.31, p 276.

Furthermore, as the Legislature stated, and as we agree, the SBTA is remedial and procedural. The general rule that a statute is presumed to operate prospectively does not apply to statutes remedial or procedural in nature. *Selk v Detroit Plastic Products*, 419 Mich 1, 10; 345 NW2d 184 (1984), opinion on resubmission 419 Mich 32; 348 NW2d 652 (1984). Statutes in furtherance of an already existing remedy, which do not create new rights or destroy existing ones, operate retrospectively unless a contrary legislative intent is manifested. *Id.* at 10; *Spencer v Clark Twp*, 142 Mich App 63, 67; 368 NW2d 897 (1985).

The combination of these principles of statutory construction lead us to conclude that § 69 of the SBTA as amended by 1987 PA 39 has retroactive effect and is applicable to Trinova.

Because the Legislature has implicitly rejected the holding in *Jones & Laughlin*, and we do likewise explicitly, the Court of Claims decision was based upon incorrect principles of law. Thus, the case must be remanded for reconsideration under the proper principles. That is, as a pending matter, the case must be decided according to the amended § 69(3), which is a directive from our Legislature as to how the relief provisions of the SBTA are to be interpreted. The instant record does not permit us to judge what effect the two "fairness" tests contained in § 69(3) have on the position of the parties or the result in this case. Accordingly, the order of the Court of Claims granting Trinova summary disposition is reversed and the case remanded for development of additional facts and a new decision in light of amended § 69(3).

Reversed and remanded. We do not retain jurisdiction.

STATE OF MICHIGAN
IN THE COURT OF CLAIMS

File No. 86-10430-CM

HON. ROBERT HOLMES BELL

TRINOVA CORPORATION, (formerly LIBBEY-OWENS-FORD COMPANY),
Plaintiff,

—vs—

STATE OF MICHIGAN, DEPARTMENT OF TREASURY, REVENUE DIVISION,
Defendant.

OPINION AND ORDER OF THE COURT

This case presents an action by plaintiff, Trinova Corporation, to recover an alleged overpayment of taxes under the Single Business Tax Act. The Department of Treasury's answer thereto includes a counterclaim, asserting plaintiff actually owes additional tax for tax year 1980. Both parties have moved for summary disposition under MCR 2.116(C)(9), asserting their opponent has failed to state a valid defense.[1]

Plaintiff is an Ohio corporation which conducts business in Michigan. For the privilege of doing business in Michigan during tax year 1980, plaintiff paid tax under

[1] Normally, a motion for summary disposition under MCR 2.116(C)(9) is based exclusively on the pleadings. Here, however, both parties have asked the Court to also consider a document entitled "Stipulated Facts" in evaluating their motions. Pursuant to this mutual request, this document is herein treated as a pleading which speaks on behalf of both parties as to both claims before the Court.

the Single Business Tax Act ("Act"), MCL 208.1 *et seq.*; MSA 7.558(1) *et seq.* Plaintiff's tax liability for 1980 was computed through application of the Act's § 45 formula. Plaintiff paid this amount, $293,528, in full. In 1985, plaintiff filed an amended single business tax return, requesting the Department of Treasury ("Department") to re-calculate its 1980 tax liability by an alternate method. When the request was denied, plaintiff filed the instant complaint, asking the Court to rule that plaintiff is entitled to use the alternate method and to award a total tax refund of $293,528. In its counterclaim, the Department, too, asserts plaintiff's 1980 single business tax liability ought to have been calculated by an alternate method. According to its proposed method, plaintiff owes additional tax in the amount of $576,804.

I

The Act imposes a specific tax on the adjusted tax base of every person who conducts business in Michigan. The "adjusted tax base" is essentially federal taxable income, subject to certain additions and subtractions enumerated at § 9 of the Act. One of these "adjustments," at § 9(5), requires the taxpayer to add compensation paid its employees to its tax base. Similarly, § 9(4)(c) requires the taxpayer to add to its tax base any tangible assets depreciation deductions which had been subtracted in arriving at federal taxable income. Thus, compensation expenses and an amount equal to depreciation deductions previously taken become part of the adjusted tax base. In order to determine what portion of the adjusted tax base of a corporation like plaintiff, which conducts business within and without Michigan, is taxable as Michigan business activity, a three-factor apportionment formula is applied. Section 45 of the Act provides:

> All of the tax base, other than the tax base derived principally from transportation, financial, or insurance carrier services or specifically allocated,

> shall be apportioned to this state by multiplying the tax base by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3.

Application of this apportionment formula is designed to produce a reasonable *approximation* of that share of a multi-state taxpayer's business activity which is attributable to Michigan. Because the resultant approximation may be more or less accurate, depending on taxpayer-specific circumstances, relief from the apportionment formula is sometimes available under § 69 of the Act:

> (1) If the apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commission may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (a) Separate accounting.
>
> (b) The exclusion of any 1 or more of the factors.
>
> (c) The inclusion of 1 or more additional factors which will fairly represent the taxpayer's business activity in this state.
>
> (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.
>
> (2) An alternate method will be effective only if it is approved by the commissioner.

Plaintiff attempted to take advantage of this § 69 relief by filing an amended return which incorporated a two-step apportionment/allocation method. This method includes allocation of actual Michigan compensation expenses and actual Michigan depreciation amounts, rather than estimation thereof through apportionment. In other words, plaintiff excluded compensation and depreciation

amounts from its preapportionment adjusted tax base, contrary to § 9. The apportionment formula was applied to plaintiff's adjusted tax base less compensation and depreciation. Then, the known amounts of plaintiff's Michigan compensation and depreciation were added to the apportionment product to yield that portion of plaintiff's total business activity attributable to Michigan. The Department refused to approve this alternate two-step method even though the Tax Tribunal and the Court of Appeals had previously recognized it as legitimate and appropriate under similar circumstances. See *Jones & Laughlin Steel Corp v Dep't of Treasury*, 145 Mich App 405; 377 NW2d 397 (1985), *lv den* 424 Mich 894 (1986).

In defense of its decision, the Department contends the *Jones & Laughlin* ruling is not a binding precedent. The Department presents arguments based on other authorities which were largely rejected by the *Jones & Laughlin* court. Adjudication of plaintiff's claim depends almost exclusively upon the force and effect of *Jones & Laughlin*.

The Jones & Laughlin Steel Corporation and Wilson Foods Corporation filed single business tax returns for tax years 1976, 1977 and 1978, using the above-described two-step method. The Department refused to approve the method. The Tax Tribunal overruled the Department, holding (1) that the statutory apportionment formula failed to accurately represent the taxpayers' Michigan business activity; and (2) that the alternate two-step method yielded a substantially more accurate result. *Jones & Laughlin Steel Corp* v *Dep't of Treasury*, MTT Docket Nos. 57892 and 57893, Opinion & Judgment dated September 5, 1984. The Court of Appeals affirmed the Tax Tribunal judgment. Thus, the Court of Appeals' *Jones & Laughlin* ruling does not establish a broad rule of general applicability. It is merely an affirmance of the Tax Tribunal's treatment of two taxpayers under the Single Business Tax Act. Yet, while it may be in-

accurate to characterize *Jones & Laughlin* as "binding precedent," to the extent the instant fact situation is materially indistinguishable from the one treated in *Jones & Laughlin*, the Court of Appeals' reasoning certainly represents persuasive authority.

Both the Tax Tribunal's and the Court of Appeals' determination that application of the statutory apportionment formula yielded inaccurate results as to Jones & Laughlin Steel and Wilson Foods rested essentially upon two findings:

> (1) that each taxpayer's actual compensation expenses attributable to Michigan was a known amount; and
>
> (2) that application of the statutory apportionment formula to each taxpayer's total compensation expenses yielded an apportioned compensation approximation more than 50% greater than each taxpayer's actual Michigan compensation expenses for each tax year.

Where these two circumstances coincided, it was determined that application of the statutory apportionment formula was unfair, justifying § 69 relief.

Based on the pleadings, it appears both circumstances are present in the instant case as well, as to both compensation and depreciation. Plaintiff's 1980 apportioned Michigan compensation is approximately 40 times greater than actual compensation ($20,308,006 vs $511,774), while apportioned Michigan depreciation is approximately 1000 times greater than actual depreciation ($2,087,078 vs $2,152).

The Department has suggested no viable grounds for distinguishing *Jones & Laughlin* from plaintiff's case. Instead, the Department argues simply the *Jones & Laughlin* reasoning is defective and should be ignored. Contrary to *Jones & Laughlin*, the Department maintains

it is not enough to show that one or even two elements of a taxpayer's business activity are over-estimated by application of the Act's formula. Rather, the Department argues, the Act's formula should be departed from only if its application results in unfairly high or unfairly low taxation.

The *Jones & Laughlin* court addressed this argument directly as follows:

> The inquiry does not turn on the end result, i.e., tax liability. Rather, it turns on whether the basis for computing tax liability is fair, i.e., is the business activity subject to taxation accurately reflected by application of the three factor formula? 145 Mich App 412.

The Court of Appeals went on to hold that where even just one element of business activity is shown, by clear and convincing evidence, to be inaccurately represented by application of the apportionment formula, § 69 relief is available.

Whether this Court agrees entirely with this ruling is immaterial. It is this Court's function to interpret and apply the Single Business Tax Act in accordance with legislative intent and the pronouncements of the state's higher courts. Accordingly, the Court believes the Court of Appeals' *Jones & Laughlin* decision is entitled to more respect than the Department is willing to acknowledge. The Court hereby adopts the reasoning employed therein and holds as a matter of law based on the pleadings that the Act's apportionment formula fails to accurately represent plaintiff's Michigan business activity.

II

It follows that plaintiff is entitled to § 69 relief. However, an alternate method of calculating plaintiff's tax base is effective only if approved by the Department. It appears the Department never passed upon the appropri-

ateness of plaintiff's proposed alternate two-step method because it believed the Act's formula was suitable. When confronted with this situation in *Jones & Laughlin*, the Tax Tribunal noted the Department had not promulgated procedural rules whereby a proposed alternate method could be evaluated. The Tax Tribunal proceeded to establish and apply its own standard. It determined that a proposed method ought to be approved if it provides a "substantially more accurate representation" of the taxpayer's Michigan business activity. The Tax Tribunal determined in *Jones & Laughlin* that the two-step method varied from the Act's apportionment formula in one respect only: its treatment of Michigan compensation expenses. Since the two-step method substituted a known actual amount for an estimated inaccurate amount, the Tax Tribunal concluded the two-step method represented the taxpayer's Michigan business activity with substantially more accuracy than the Act's apportionment formula. Thus, the taxpayers were permitted to use the two-step method over the Department's objection. The Court of Appeals affirmed this result.

Here, the pleadings suggest similar treatment is justified. Applying the standard established in *Jones & Laughlin*, it is clear the Department should have approved plaintiff's proposed two-step method. It represents plaintiff's Michigan compensation and depreciation with substantially more accuracy than the Act's apportionment formula and does not further distort any other element of plaintiff's business activity. The Department has not disputed this fact, but objects to the resultant reduction in plaintiff's tax liability. Consistent with the Court of Appeals' rejection of this argument, the Court concludes the Department has failed to state a valid defense. Plaintiff's unrefuted allegation that the two-step method represents two elements of its business activity with substantially more accuracy than the apportionment formula justifies summary declaration in plaintiff's favor.

Whether plaintiff is entitled to refund of tax paid, however, is a question which depends in part upon resolution of the Department's counterclaim.

III

Although the Department, in defending against plaintiff's claim, contends the Act's formula does fairly represent plaintiff's 1980 Michigan business activity, its counterclaim asserts the contrary position. The Department alleges therein that application of the Act's formula fails to fairly represent (1) "the extent of Plaintiff's use of the State of Michigan as a market for its products;" and (2) "the significant amount of receipts which Plaintiff derives from its business activities in Michigan." The Department proposes an alternate method based solely upon plaintiff's Michigan sales. This method, too, is said to represent plaintiff's Michigan business activity substantially more accurately than the Act's apportionment formula. Asserting plaintiff has stated no valid defense to the claim, the Department moves for summary disposition in its favor.

Plaintiff admits its actual 1980 Michigan "sales," (gross receipts obtained in consideration for transfer of inventory to customers in the ordinary course of business and for performance of services), amounted to $103,981,354. Using the Act's formula, Michigan sales were estimated to be only $35,196,000. While admitting this circumstance may justify departure from the Act's formula, plaintiff contends the Department's proposed alternate method is not substantially more accurate. In fact, both parties acknowledge that use of the Department's proposed one-factor formula results in even more extreme exaggerations of plaintiff's Michigan compensation and depreciation than use of the Act's formula. (Stipulated Facts, pp 6, 7.) The very evil which the Tax Tribunal and Court of Appeals sought to avoid in *Jones & Laughlin*, taxation of extra-territorial business activity,

is thus compounded by use of the Department's proposed formula. This cannot be permitted. The Court must conclude the Department's proposed one-factor method does not represent plaintiff's business activity with substantially more accuracy than the Act's apportionment formula.

It must be remembered that the Act's apportionment formula has been recognized as the "preferred method established by the Legislature for determining the extent of a taxpayer's business activity in Michigan." *Payne & Dolan of Wisconsin, Inc* v *Dep't of Treasury*, 138 Mich App 418, 424; 360 NW2d 208 (1984). The two-step method proposed by plaintiff, *supra*, pays deference to this preference by departing therefrom minimally. It applies the Act's apportionment formula to all elements of plaintiff's tax base except compensation and depreciation. It further ensures that plaintiff's compensation and depreciation are even more accurately represented by allocating the actual amounts. While plaintiff's two-step method does not correct the underestimation of plaintiff's Michigan sales caused by use of the Act's formula, neither does it compound the distortion. Plaintiff's method does not represent its business activity with perfect exactitude, but it is superior to the Act's formula.

On the other hand, the Department's proposed alternate method represents a profound departure from the Act's formula. It replaces the legislatively preferred three-factor formula with a one-factor (sales) formula, eliminating the payroll and property factors from the equation. Not only does it appear to attach inordinate importance to plaintiff's sales, but it greatly distorts plaintiff's compensation and depreciation expenses. It is anything but an improvement upon the Act's formula.

The Court finds that plaintiff has stated a valid defense to the counterclaim. The Department's motion for summary disposition must be denied. Furthermore, the pleadings compel the conclusion that, as to the Department's counterclaim, there is no genuine issue of material fact. As a matter of law, the Court holds the Department's proposed alternate method is not substantially more accurate than the Act's formula. The Department is not entitled under § 69 of the Act to employ its proposed one-factor formula in determining plaintiff's single business tax. Plaintiff is entitled to summary disposition under MCR 2.116(I)(1).

IV

Based on the premises, the Department's counterclaim is hereby dismissed. Further, plaintiff is awarded summary disposition as to its claim under MCR 2.116(C)(9). The Department is hereby directed to accept and process plaintiff's amended single business tax returns for tax year 1980, refunding any overpayment and interest to which plaintiff is entitled.

IT IS SO ORDERED.

Dated: May 5, 1987

/s/ Robert Holmes Bell
ROBERT HOLMES BELL
Circuit Judge sitting in the
Court of Claims

STATE OF MICHIGAN
COURT OF CLAIMS

Civil Action No. 86-10430-CM

HON. ROBERT HOLMES BELL

TRINOVA CORPORATION, formerly
LIBBEY-OWENS-FORD COMPANY,
Plaintiff,

v

STATE OF MICHIGAN, DEPARTMENT OF TREASURY,
REVENUE DIVISION,
Defendant.

ERNEST GETZ (P13944)
ELIZABETH TRICKEY (P38429)
Attorneys for Plaintiff
DICKINSON, WRIGHT, MOON, VAN DUSEN & FREEMAN
800 First National Building
Detroit, Michigan 48226
(313) 223-3500

CHARLES E. LIKEN (P16677)
Attorney for Defendant
Assistant Attorney General
First Floor, Treasury Building
Lansing, Michigan 48922
(517) 373-3203

STIPULATED FACTS

Plaintiff, Trinova Corporation, and defendant, State of Michigan, Department of Treasury, Revenue Division, through their attorneys, stipulate to the following facts:

1. Plaintiff is an Ohio corporation duly qualified under the laws of Michigan, with its principal office at 1705 Indian Wood Circle, Maumee, Ohio 43537. Plaintiff pays taxes to the State of Michigan pursuant to the Single Business Tax Act ("SBT"), [MCLA sec. 208.1 *et seq.*; MSA 7.588(1) *et seq.*]

2. Defendant is the State of Michigan, Department of Treasury, Revenue Division, which is the governmental agency charged with the administration of the SBT.

3. Because plaintiff has business activities which are taxable both within and without Michigan, its tax base is apportioned pursuant to SBT 41.

4. Plaintiff's Michigan activity in 1980 consisted of an office with six clerical workers to support eight sales people who solicited orders for plaintiff's glass division and provided liaison with its Michigan customers. More than one fourth of plaintiff's worldwide sales were made in Michigan.

5. Plaintiff contends that since its operations are nearly all located outside of Michigan, and are labor and capital intensive, the use of the standard statutory apportionment formula contained in the SBT 45 does not reasonably or fairly reflect the actual amount of plaintiff's business activity in Michigan.

6. For the purposes of the 1980 Michigan Single Business Tax, plaintiff's tax base was apportioned to Michigan based upon apportionment percentages determined pursuant to SBT 45 through 52. Plaintiff's tax base was multiplied by the SBT apportionment percentage for that year. The SBT apportionment percentage is a fraction, the numerator of which is the sum of the property factor (SBT 46), the payroll factor (SBT 49) and the sales factor (SBT 51), and the denominator of which is three.

7. The SBT apportionment percentage (the average of the property, payroll and sales factor percentages) was

determined by the defendant for the year 1980 as follows:

	1980
	%
Property Factor	.0930
Payroll Factor	.2328
Sales Factor	26.5892
Total Percentage	26.915
Apportionment %	8.9717
(Total percentage divided by three)	

8. Although the components of plaintiff's tax base include U.S. taxable income, compensation, depreciation, taxes, royalties, interest, etc., the amounts of compensation and depreciation, and the percentages of plaintiff's tax base composed of compensation and depreciation during the year 1980 were:

	1980
Tax Base:	$221,125,319
Total Compensation:	$226,356,271
Percentage of Tax Base:	102%
Total Depreciation:	$ 23,262,909
Percentage of Tax Base:	10.52%

9. The apportioned compensation compared to actual Michigan compensation, is as follows during the year 1980:

Total Compensation	Apportionment Percentage	Apportioned Compensation	Actual Michigan Compensation
$		$	$
226,356,271	8.9717	20,308,006	511,774

Actual Michigan compensation is 2.52% of the apportioned compensation.

10. The apportioned depreciation compared to actual depreciation is as follows for the year 1980:

Total Depreciation:	$23,262,909
Apportionment Percentage:	8.9717
Apportioned Depreciation:	$ 2,087,078
Depreciation Attributable to Michigan:	$ 2,152

Depreciation attributable to Michigan is .1% of depreciation apportioned to Michigan.

11. *Jones & Laughlin Steel Corporation* v *Michigan Department of Treasury* and *Wilson Foods Corporation* v *Michigan Department of Treasury*, 145 Mich App 405 (1985); app *lv den*, 484 Mich 894 (1986) motion for reconsideration *den*, Michigan Supreme Court No. 77291 & 77292 (October 22, 1986) approves an SBT 69 alternative method of apportionment and allocation. It offered relief to two taxpayers whose compensation attributable to Michigan was identifiable and overapportioned to Michigan under the three factor formula. Under this method the three factor apportionment percentage was applied to the taxpayer's SBT 9 tax base excluding compensation. To the apportioned amount was added the full amount of actual Michigan compensation.

12. On or about October 13, 1985, plaintiff timely filed with the defendant an Amended Single Business Tax Annual Return for the year 1980, plus a request that plaintiff be allowed to utilize the method of allocation and apportionment endorsed in *Jones & Laughlin, supra*, pursuant to the SBT 69 relief provisions. The amended returns reflect the application of the SBT 69 alternative method of apportionment and allocation set forth in *Jones & Laughlin, supra*, and a refund request of $293,528.

13. Application of plaintiff's alternative method would lead to an overpayment of single business tax for 1980 in the amount of $293,528, which is the entire amount of tax paid for 1980.

14. On November 12, 1985 the defendant denied plaintiff's request for SBT 69 relief and refund.

15. SBT section 69 provides that an alternate method will be effective only if it is approved by the Commissioner.

16. Plaintiff's sales for 1980, which are precisely identified, were as follows:

Total Sales:	$391,065,866
Sales in Michigan:	$103,981,354
Percentage of Michigan Sales to all Sales:	26.5892%

17. Apportioned sales, under the three factor formula, compared to actual sales in Michigan for the year 1980 are as follows:

Total Sales	$391,065,866
Apportionment Percentage	8.9717
Apportioned Sales	$ 35,196,000
Actual Michigan Sales	$103,981,354

Sales attributable to Michigan are 33.8% of actual Michigan Sales and under plaintiff's proposal would remain so even though attributed compensation would be 100% of Michigan compensation.

18. The defendant's proposed alternative method of calculating plaintiff's single business taxes by use of a one factor formula consisting of a sales factor would be computed as follows:

Tax Base:	$221,125,319
X Sales Factor:	26.5892%
Apportioned Tax Base:	$ 58,795,453
Less Capital Acquisition deduction:	$ 9,063
Adjusted Tax Base:	$ 58,786,390
Less 37% Compensation deduction:	$ 21,750,964
Taxable Amount:	$ 37,035,426
Tax at 2.35%:	$ 870,332

19. Application of the one factor formula consisting of the sales factor would apportion plaintiff's compensation to Michigan as follows:

1980 Total Compensation:	$226,356,271
Actual Michigan Compensation:	$ 511,774
Compensation Apportioned to Michigan:	$ 60,186,322
Percentage of total Compensation to Michigan Apportioned Compensation:	26.6%

This percentage is the same as the percentage of the plaintiff's sales in Michigan to total sales.

20. Application of the one factor formula consisting of the sales factor would apportion plaintiff's depreciation to Michigan as follows:

1980 Total Depreciation:	$23,262,909
Depreciation Attributable to Michigan:	$ 2,152
Depreciation Apportioned to Michigan:	$ 6,185,421
Percentage of total Depreciation to Michigan Apportioned Depreciation:	26.6%

This percentage is the same as the percentage of the plaintiff's sales in Michigan to total sales.

21. Application of defendant's alternative method would lead to an underpayment of single business tax for 1980 in the amount of $576,804.

FRANK J. KELLEY
Attorney General

RICHARD R. ROESH
CHARLES E. LIKEN
Assistant Attorneys General

By: _____
CHARLES E. LIKEN
(P16677)
Assistant Attorney General
Attorneys for Defendant
First Floor,
Treasury Building
Lansing, Michigan 48922
(517) 373-3203

Dated: _____

DICKINSON, WRIGHT, MOON,
VAN DUSEN & FREEMAN

By: _____
ERNEST GETZ (P13944)

By: _____
ELIZABETH TRICKEY
(P38429)
Attorneys for Plaintiff
800 First National Building
Detroit, Michigan 48226
(313) 223-3500

Dated: _____

STATUTORY PROVISIONS

Mich. Comp. Laws § 208.42 (1979). Conditions to taxpayer being taxable in another state.

Sec. 42. For purposes of apportionment of the tax base from business activities under this act, a taxpayer is taxable in another state if, (a) in that state he is subject to a business privilege tax, a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business or a corporate stock tax, a tax of the type imposed under this act, or (b) that state has jurisdiction to subject the taxpayer to 1 or more of the taxes regardless of whether, in fact, the state does or does not.

Mich. Comp. Laws § 208.45 (1979). Computation of tax base apportioned for state.

Sec. 45. All of the tax base, other than the tax base derived principally from transportation, financial, or insurance carrier services or specifically allocated, shall be apportioned to this state by multiplying the tax base by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3.

Mich. Comp. Laws § 208.46 (1979). Property factor.

Sec. 46. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented in this state during the tax year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented during the tax year.

Mich. Comp. Laws § 208.49 (1979). Payroll factor; "wages" defined.

Sec. 49. The payroll factor is a fraction, the numerator of which is the total wages paid in this state during the tax year by the taxpayer and the denominator of

which is the total wages paid everywhere during the tax year by the taxpayer. For the purposes of this chapter only, "wages" means wages as defined in section 3401 of the internal revenue code.

Mich. Comp. Laws § 208.51 (1979). Sales factor.

Sec. 51. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax year, and the denominator of which is the total sales of the taxpayer everywhere during the tax year.

Mich. Comp. Laws § 208.69 (1979). Apportionment not fairly representing extent of taxpayer's business activity in state.

Sec. 69. (1) If the apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commissioner may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) Separate accounting.

(b) The exclusion of any 1 or more of the factors.

(c) The inclusion of 1 or more additional factors which will fairly represent the taxpayer's business activity in this state.

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.

(2) An alternate method will be effective only if it is approved by the commissioner.

Mich. Comp. Laws Ann. § 208.69 (West 1979). Relief as to tax base (as amended by 1987 Pub. Act 39)

Sec. 69. (1) If the apportionment provisions of this act do not fairly represent the extent of the taxpayer's

business activity in this state, the taxpayer may petition for or the commissioner may require the following, in respect to all or a part of the taxpayer's business activity, if reasonable:

(a) Separate accounting.

(b) The exclusion of 1 or more of the factors.

(c) The inclusion of 1 or more additional factors which will fairly represent the taxpayer's business activity in this state.

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.

(2) An alternate method will be effective only if it is approved by the commissioner.

(3) The apportionment provisions of this act shall fairly represent the business activity attributed to the taxpayer in this state, taken as a whole and without a separate examination of the specific elements of the tax base such as depreciation, compensation, or income, unless it can be demonstrated that the business activity attributed to the taxpayer in this state is out of all appropriate proportion to the actual business transacted in this state and leads to a grossly distorted result. A taxpayer's business activity shall be presumed to be fairly represented if the adjusted tax base computed without regard to the reduction based upon gross receipts permitted by section 31(2) is not greater than the adjusted tax base computed after application of the reduction based upon gross receipts permitted by section 31(2) or if the adjusted tax base is not greater than the adjusted tax base which would result from an apportioned tax base computed by using the apportionment formula prescribed for a corporate income tax or franchise tax in the taxpayer's business domicile. The taxpayer's business domicile is the state in which the sum of the tax-

payer's payroll factor and property factor is greatest. However, if the taxpayer fails to satisfy either of these tests, the taxpayer's business activity shall not be presumed to not be fairly represented.

(4) The filing of a return or an amended return shall not be considered a petition for the purposes of subsection (1).

(5) As used in this section, "adjusted tax base" means that term as defined in section 31.

Amended by P.A.1987, No. 39, § 1, Imd. Eff. June 9.

MICHIGAN COURT OF APPEALS

Docket Nos. 80472, 80473

JONES & LAUGHLIN STEEL CORPORATION

v.

DEPARTMENT OF TREASURY

WILSON FOODS CORPORATION

v.

DEPARTMENT OF TREASURY

Submitted June 10, 1985, at Lansing

Decided September 3, 1985

Leave to appeal applied for

Jones & Laughlin Steel Corporation and Wilson Foods Corporation each petitioned the Tax Tribunal for relief from single business tax assessments made by the Department of Treasury against them. The Tax Tribunal consolidated the petitions. Both petitioners are incorporated in foreign states and have their principal places of business in foreign states. Their products are sold throughout the United States. Jones & Laughlin operates a marketing and sales office, a manufacturing plant, and

a retail outlet in Michigan. Wilson Foods operates marketing and sales offices and utilizes certain salesmen in Michigan. They claimed that application of the statutory three-factor formula for apportionment distorted the business activity of the petitioners in the state and that they were thus entitled to an alternative method of apportionment provided for by statute. The Treasury Department contended that they would only be entitled to relief if the final tax liability was out of proportion to the petitioners' business activity in the state. The Tax Tribunal held that the petitioners were entitled to the requested relief. The Treasury Department appealed. *Held:*

The proper test for determining whether the apportionment provisions of the Single Business Tax Act fairly represent the extent of the taxpayer's business activity in the state, thus allowing the use of an alternative method of allocation, is whether the statutorily prescribed method of apportionment accurately reflects the extent of the taxpayer's business activity in the state.

Affirmed.

1. TAXATION—SINGLE BUSINESS TAX—APPORTIONMENT—ALTERNATIVE METHODS OF APPORTIONMENT—FAIRNESS—BURDEN OF PROOF.

The proper test for determining whether the apportionment provisions of the Single Business Tax Act fairly represent the extent of the taxpayer's business activity in the state, thus allowing the use of an alternative method of allocation, is whether the statutorily prescribed method of apportionment accurately reflects the extent of the taxpayer's business activity in the state; the burden of proving distortion of business activity in the state by use of the statutorily prescribed apportionment method is upon the party seeking to use an alternative method.

2. TAXATION—SINGLE BUSINESS TAX.

The single business tax is a levy on the privilege of doing business in the state.

Dickinson, Wright, Moon, Van Dusen & Freeman (by *Peter S. Sheldon*), for appellees.

Frank J. Kelley, Attorney General, *Louis J. Caruso*, Solicitor General, and *Richard R. Roesch* and *Charles E. Liken*, Assistants Attorney General, for the Department of Treasury.

OPINION OF THE COURT

Before: MACKENZIE, P.J., and HOOD and J.E. MIES,* JJ.

MACKENZIE, P.J. Respondent appeals as of right from a judgment of the Michigan Tax Tribunal cancelling assessments of single business tax deficiency issued by respondent against petitioners. We affirm.

Jones & Laughlin Steel Corporation and Wilson Foods Corporation are incorporated in foreign states and have their principal places of business in foreign states. Their products are sold throughout the United States. Jones & Laughlin operates a marketing and sales office, a manufacturing plant, and a retail sales outlet in Michigan. Wilson Foods operates marketing and sales offices and utilizes certain salesmen in Michigan.

The Single Business Tax Act, MCL 208.1 *et seq.*; MSA 7.558(1) *et seq.*, imposes a specific tax on the adjusted tax base of every person with business activity in this state. *Town & Country Dodge, Inc. v Dep't of Treasury*, 420 Mich 226, 234-235; 362 NW2d 618 (1984); MCL 208.31(1); MSA 7.558(31)(1). "Adjusted tax base" is essentially federal taxable income, subject to certain additions and subtractions enumerated at MCL 208.9; MSA

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* Circuit judge, sitting on the Court of Appeals by assignment.

7.558(9). One of these "section 9 adjustments" to the tax base requires the taxpayer to add compensation paid its employees to taxable income. MCL 208.9(5); MSA 7.558(9)(5).

Since petitioners have taxable business activities both within and without Michigan, determination of their single business tax liability requires that each apportion its adjusted tax base to reflect Michigan activity. See MCL 208.41; MSA 7.558(41). Apportionment is achieved by applying to the adjusted tax base a three-factor formula:

> "All of the tax base, other than the tax base derived principally from transportation, financial, or insurance carrier services or specifically allocated, shall be apportioned to this state by multiplying the tax base by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3." MCL 208.45; MSA 7.558(45).

The three-factor formula produces an apportionment percentage of the taxpayer's business activity attributable to Michigan. By multiplying the taxpayer's adjusted tax base by this apportionment percentage, the taxpayer's Michigan tax base is computed.

Application of the apportionment percentage derived from the statutory formula to petitioners' actual total compensation paid their employees in Michigan yielded a value far in excess of actual compensation paid. During 1976, for example, the actual compensation paid in Michigan by Wilson Foods was $91,642, whereas its apportioned compensation was $2,975,400. Accordingly, from 1976 to 1978, in lieu of calculating their Michigan tax base as provided by the statutory apportionment formula, both petitioners used a two-step apportionment/allocation calculation. First, each petitioner applied the statutory three-factor apportionment formula to its adjusted tax base exclusive of the § 9 compensation adjustment. Second, they allocated the exact amount of compensation paid which was attributable to Michigan. From this sum, they determined their single business tax liability.

Pursuant to audits conducted by respondent, petitioners' single business tax for the years 1976-1978 was recalculated by including compensation as part of each petitioners' adjusted tax base and applying the statutory apportionment formula. Using this method, respondent assessed deficiencies of $556,697 and $37,694 against Jones & Laughlin and Wilson Foods, respectively.

The Tax Tribunal ordered the cancellation of the assessed deficiencies pursuant to § 69 of the Single Business Tax Act, which provides in relevant part:

> "(1) If the apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commissioner may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> * * *
>
> "(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base." MCL 208.69; MSA 7.558(69).

The sole issue before this Court is whether on these facts petitioners were entitled to § 69 relief. What constitutes "fairness" for purposes of this section is a question of first impression. Respondent contends that fairness is tested by weighing the reasonableness of the taxpayer's final tax liability against the level of its business activity within the state, citing *Armco Steel Corp v Dep't of Revenue*, 359 Mich 430; 102 NW2d 552 (1960), *app dis* 364 US 337; 81 S Ct 124; 5 L Ed 2d 99 (1960).

The problem with respondent's proposed test is that it does not focus on the fairness of the *apportionment* provisions of the act, for which § 69 is designed to provide relief. We believe instead that the proper test for invoking § 69 relief is whether the taxpayer's Michigan tax base, as derived from the application of the three-factor apportionment formula to its adjusted tax base, accurately reflects the extent of the taxpayer's business activity within the state.

Section 69 is, for pertinent purposes, identical to the relief provision of the Income Tax Act of 1967, alternatively referred to as the Michigan corporate income tax, see MCL 206.195; MSA 7.557(1195), and the provision affording relief from the apportionment formula which was once used in determining franchise fees, see MCL 450.305(5); MSA 21.208(5), repealed by 1975 PA 230, § 1. The single business tax is, and the franchise fee was, a levy on the privilege of doing business in the state. *Acco Industries, Inc v Dept of Treasury*, 134 Mich App 316; 350 NW2d 874 (1984), *lv den* 421 Mich 856 (1985); *International Telephone & Telegraph Corp v Michigan*, 50 Mich App 5; 213 NW2d 226 (1973), *lv den* 391 Mich 774 (1974). Although the corporate business income tax is a tax on income, "the logic employed by the court [in interpreting the relief provision of the Michigan corporate income tax] should be equally applicable to the single business tax since similar provisions exist for combined filing". Weithorn & Zartarian, *Taxation: State and Local*, 30 Wayne Law Review 789, 790 (1984). Thus, we look to interpretations of the relief provisions found in those statutes to determine what is meant by the proviso that "the apportionment provisions * * * do not fairly represent the extent of the taxpayer's business activity in this state".

In *Donovan Construction Co v Dep't of Treasury*, 126 Mich App 11; 337 NW2d 297 (1983), *lv den* 419 Mich 894 (1984), the Treasury Department requested that

plaintiff's corporate income tax be computed through a separate accounting method, which method would yield a greater tax liability than the statutory three-factor apportionment formula. The Department argued that the apportionment formula resulted in a "gross disparity" in tax liability. This Court upheld use of the apportionment formula, stating:

> "Only if formulary apportionment does not fairly represent the extent of the taxpayer's business activity in the state may a different method, such as separate accounting, be employed. The party seeking to employ an alternate apportionment method has the burden of showing that the formulary apportionment method is inappropriate by clear and convincing evidence. * * * Evidence introduced to overcome the formula method of allocation must address each element of the formula's equation." 126 Mich App 21-22.

Elucidating on the type of showing which must be made, this Court stated:

> "[A]pplication of the separate accounting [or some other alternative formula] solely on the basis that there is a gross disparity in the results between the different methods results in the use of the separate accounting because the tax liability is greater and not because separate accounting more accurately reflects the corporate taxpayer's unitary business in the state. This Court is of the opinion that, *in addition to the gross disparity between the results, additional evidence should be considered in demonstrating that the statutory formula inadequately or inaccurately represents the taxpayer's unitary business activity in the taxing state*". 126 Mich App 21, fn 2. (Emphasis added.)

In *Payne & Dolan of Wisconsin, Inc v Dep't of Treasury*, 138 Mich App 418; 360 NW2d 208 (1984), the

Treasury Department also contended that for corporate income tax purposes the separate accounting method more fairly represented the taxpayer's business activities in Michigan. The basis of the contention was again the "gross disparity" between petitioner's taxable income under the apportionment formula and the separate accounting method. This Court rejected the argument, stating:

> "To permit respondent to meet its burden by merely pointing to a 'gross disparity' between taxable income under the separate accounting method as compared with taxable income under the apportionment formula would necessarily involve a presumption that the separate accounting method is a more accurate means of determining a taxpayer's business activity in Michigan than is the apportionment formula. We concur with the *Donovan* panel that *to meet its burden the state must show that the statutorily-preferred apportionment formula is itself inadequate as a means of fairly determining the particular taxpayer's extent of business activity in Michigan*". 138 Mich App 424. (Emphasis added.)

In *Donovan* and *Payne & Dolan*, the Treasury Department based its requests for relief primarily on a showing of gross disparity in tax liability results and not on a showing that the apportionment formula distorted business activity within the state. Therefore, this Court denied relief. Similarly, because the burden of showing distorted activity was not met in *International Telephone & Telegraph Corp, supra*, the corporation was not entitled to relief in computing franchise fees. The basis for denial or relief in these cases was *not*, as respondent suggests, that the resulting franchise fee or tax liability seemed reasonable or not excessive. The inquiry does not turn on the end result, *i.e.*, tax liability. Rather, it turns on whether the basis for computing tax liability

is fair, *i.e.*, is the business activity subject to taxation accurately reflected by application of the three-factor formula?

This Court reviews Tax Tribunal decisions to determine whether such decisions are authorized by law and whether they are supported by competent, material, and substantial evidence on the whole record. *Terco, Inc. v Dep't of Treasury*, 127 Mich App 220, 223; 339 NW2d 17 (1983); Const 1963, art 6, § 28. Based on *Donovan, Payne & Dolan*, and *International Telephone & Telegraph Corp, supra*, it is clear that the Tax Tribunal's analysis was based on an accurate statement and understanding of the law. Both the Single Business Tax Act and similar provisions in other acts permit relief if business activity within the state is distorted by the apportionment formula. Therefore, the Tax Tribunal's decision granting relief will be upheld if the evidence regarding business activity supports its determination.

The parties stipulated below that (1) 85 percent to 100 percent of the petitioners' adjusted tax bases were comprised of compensation; (2) use of the apportionment formula indicated that the compensation was $12,000,000 to $17,000,000 higher than actual compensation for Jones & Laughlin and $2,000,000 higher than actual compensation for Wilson Foods for each of the three years in question; and (3) the compensation attributable to Michigan could be precisely calculated for both corporations. Petitioners did not merely show a gross disparity in tax liability depending on the accounting method employed. Instead, based on the stipulated facts, petitioners presented evidence which demonstrated that the three-factor formula over-apportioned or excessively attributed compensation to Michigan. The facts revealed that the compensation component of business activity subject to taxation was overstated by approximately 50 percent. As required by *Donovan, supra*, p 21, fn 2, petitioners pre-

sented clear and convincing evidence "that the statutory formula inadequately or inaccurately represent[ed] [their] unitary business activity in the taxing state". We thus conclude that the decision of the Tax Tribunal was authorized by law and supported by competent, material, and substantial evidence on the whole record.

Affirmed.

[SEAL]

STATE OF MICHIGAN
OFFICE OF THE GOVERNOR
Lansing

James J. Blanchard
Governor

IN THE SUPREME COURT OF THE
STATE OF MICHIGAN

EXECUTIVE MESSAGE OF JAMES J. BLANCHARD, GOVERNOR

To: The Honorable Chief Justice and Associate Justices of the Michigan Supreme Court

James J. Blanchard, Governor of the State of Michigan, pursuant to MCR 7.305(A), respectfully advises the Court as follows:

I. *Introduction.*

One of the primary purposes of the Michigan Single Business Tax ("SBT"), when enacted, "was to promote the development and investment of business within Michigan."[1] In direct contravention of that legislative intent, the Michigan Court of Appeals recently decided a case which interpreted the SBT in such a way as to reward taxpayers who locate job-creating activities outside of Michigan and which penalizes those employers who increase employment within the State.

That decision by the Michigan Court of Appeals is *Jones & Laughlin Steel Corp* v *Treasury Dept*, 145 Mich App 405, 377 NW2d 397 (1985), *lv den* 424 Mich 895

[1] *See ACCO Industries* v *Treasury Dept*, 2 CCH Mich St Tax Rpts ¶ 200-983, page 10,553, 10,557 (Michigan Tax Tribunal, 1983), *aff'd* 134 Mich App 316; 350 NW2d 874 (1984).

1986), (hereinafter referred to as "*J&L*"). The Michigan Department of Treasury, with the support of the Motor Vehicle Manufacturers Association, asked your Court to review the *J&L* decision on the grounds that the decision was clearly erroneous as a matter of law and represented a serious threat to Michigan's economic recovery. The Court, with two Justices dissenting, declined to hear the case.

The Court of Appeals' decision in *J&L* has created confusion and chaos for taxpayers and taxing authorities alike. The Michigan Deparement of Treasury continues to believe that *J&L* is not good law. Nevertheless, corporate taxpayers which are based outside of Michigan and which are able to take advantage of the *J&L* rationale, because the majority of their work force is located out-of-state, have flooded the courts with claims for refund. As of the date of this Executive Message, nearly 300 cases involving over $96,000,000 are pending.

As shown by several recent lower court decisions, including *AMP, Inc* v *Treasury Dept*, Court of Claims No 86-10216-CM ("AMP"), the lower courts view *J&L* as a "per-se" rule to be applied as a matter of law.[2] The *AMP* decision has been appealed by the Michigan Department of Treasury and now is pending before the Michigan Court of Appeals.[3] For reasons which are more fully detailed below, I believe it is imperative that the Supreme Court review the rationale underlying the *J&L*

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[2] In *Trinova Corp* v *State of Mich*, Court of Claims No. 86-10430-CM, the Court in its opinion "adopts the reasoning employed therein [*J&L* decision] and holds AS A MATTER OF LAW . . . that the [SBT] Act's apportionment formula fails to accurately represent plaintiff's Michigan business activity." (Bracketed material added; emphasis supplied).

[3] Michigan Court of Appeals Docket No. 100512.

AMP produces electrical and electronic connection devices, is headquartered in Harrisburg, PA, and has approximately 22,000 employees in the U.S. and 25 other countries.

and *AMP* decisions. Accordingly, I am asking in this Executive Message that the Supreme Court authorize the Michigan Court of Appeals to certify the controlling question of law presented by the *AMP* case.

On June 9, 1987 I signed into law 1987 PA 39 which was passed unanimously by both the Michigan Senate and House of Representatives. This legislation (attached hereto as Exhibit A) responds to the *J&L* rationale by declaring as the Legislature's intent that the SBT "is an indivisible value added type of tax and not a combination or series of several smaller taxes and that relief from formulary apportionment should be granted only under extraordinary circumstances."

The Act declares that the apportionment provisions of the SBT "fairly represent the business activity attributed to the taxpayer in this state, taken as a whole and without a separate examination of the specific elements of the tax base such as depreciation, compensation, or income, unless it can be demonstrated that the business activity attributed to the taxpayer in this state is out of all appropriate proportion to the actual business transacted in this state and leads to a grossly distorted result." The Act sets forth two quantitative tests to be employed in determining if the statutory apportionment provisions result in fair attribution of business activity.

In Section 2 of Act 39, the Legislature declares that its provisions are "curative, expressing the original intent of the legislature . . .".

It appears obvious that the Legislature sought to put an end to the flood of *J&L* litigation by declaring its unmistakable intent that the SBT shall be treated as a tax upon business activities, not as taxes upon elements of the tax base. I believe that *J&L* and *AMP* were wrongly decided even under prior law. 1987 PA 39 provides further evidence that the lower courts have erred in their construction of the apportionment issue.

Yet, many litigants which rely upon the *J&L* rationale postulate in their pleadings that the apportionment method upheld in *J&L* is constitutionally mandated and that the apportionment provisions of the SBT are constitutionally defective. These postulates will generate prolonged litigation.

II. *Background.*

The Michigan Single Business Tax is a modified "value added" tax. As such, the SBT is not designed to tax what the taxpayer derives from the economy (*i.e.*, income) but, rather, is designed to tax the value added by the taxpayer to the economy. Consistent with the value added nature of the SBT, a taxpayer's tax base is computed by starting with its net income from all operations and then adding such items as total compensation, royalties, interest, etc., all of which reflect value added to a product or service. For a multistate taxpayer, that tax base may be described as a "universal tax base" because it reflects the multi-state taxpayer's operations both within and without Michigan. For such a taxpayer, computing its universal tax base is only the first step in determining its SBT liability. The multi-state taxpayer normally applies a standard three-factor apportionment formula to determine the fraction of its universal tax base which will be subject to Michigan tax. The resulting number is referred to herein as the "Michigan tax base." and that is the figure ultimately used to compute the taxpayer's SBT liability.

The standard "three-factor" apportionment formula is based on the ratio of the taxpayer's property, payroll and sales in Michigan to its property, payroll and sales everywhere. That apportionment formula has been used throughout the United States for many years as an appropriate way of apportioning, for a variety of tax purposes, a multistate taxpayer's business activity among different states.

In the unusual event that the apportionment provisions of the SBT "do not fairly represent the extent of the taxpayer's business activity in" Michigan, Section 69 of the SBT Act, MCL 208.69; MSA 7.558(69), authorizes the use of other methods to produce an equitable allocation and apportionment of tax base. In *J&L*, despite the absence of any showing that the statutory apportionment formula of the SBT did "not fairly represent the extent of the taxpayer's business activity in" Michigan, the Court of Appeals nevertheless allowed the taxpayer to ignore the traditional three-factor formula and substitute its own formula.

The formula devised by the taxpayer and approved by the Court of Appeals in *J&L*, and followed by the Court of Claims in *AMP*, treats compensation differently than all other elements of the SBT universal tax base. In *J&L*, rather than the taxpayer including compensation in its universal tax base and then applying the statutory three-factor formula to determine its Michigan tax base, the taxpayer was allowed to use the following procedure:

1. The taxpayer's universal tax base was computed *excluding* compensation, and then was apportioned to Michigan using the statutory three-factor formula.

2. The taxpayer then added to the resulting figure its Michigan payroll and a portion of fringe benefits (i.e., that percentage of all fringe benefits which corresponds to the percentage which the Michigan payroll bears to all payroll) to determine its Michigan tax base.

In short, the taxpayer was allowed to compute its Michigan tax base by first apportioning in the statutory manner all elements of its universal tax base except compensation, and then allocating (*i.e.*, simply plugging-in) its Michigan direct payroll plus a portion of fringe benefits. Because the taxpayer in J&L employed a substantial majority of its workforce outside the State of Michigan, its SBT liability was significantly reduced by the use of that procedure.

III. *The implication of J&L, AMP and related decisions are contrary to the best interests of the State's economy and to the policies underlying the enactment of the SBT*

To date, the *J&L* rationale has been applied only to reduce the tax liability of taxpayers such as Jones & Laughlin and AMP Incorporated which are based outside the State of Michigan. The Michigan Department of Treasury now is asserting in a counterclaim filed in litigation pending between General Motors Corporation and the Michigan Department of Treasury, that the *J&L/AMP* rationale, if constitutionally mandated, should be applied to significantly increase the SBT liability of taxpayers like GM who have large workforces in the State of Michigan.[4] In its counterclaim against GM the Treasury contends, pursuant to the *J&L* rationale, that GM is liable for additional single business tax of approximately $45 million per year.

If the rationale underlying *J&L* and *AMP* were extended as suggested by the Treasury in its lawsuit against GM, major Michigan-based employers would, like GM, be adversely affected. The decision would have the practical effect of substantially converting the SBT into a tax on *Michigan* payrolls. Accordingly, any increase in Michigan payrolls would cause a large, directly allocated increase in Michigan tax base and, consequently, in SBT liability. Conversely, if the taxpayer expanded its activity instead in another state with a traditional income tax, its Michigan tax base would decrease in proportion to the increased out-of-state payroll. Moreover, because in a traditional income tax system the additional compensation paid in the other state would be a tax deduction, the taxpayer would gain a significant tax advantage in the other state where the expanded activity was lo-

[4] That lawsuit is titled *General Motors Corp and Combined Subsidiaries* v *State of Michigan, Treasury Dept, Revenue Div*, Court of Claims No. 83-8995-CZ.

cated. Thus, *J&L AMP* create a strong disincentive to locating in Michigan any new or expanded business activity which includes significant employment. Similarly, the decisions in those cases amount to a judicially created tax incentive to move labor-intensive activities outside of Michigan.

Such a result is clearly contrary to one of the primary purposes of the SBT, namely to promote the development and investment of business *within* Michigan. Indeed, the rationale of *J&L* stands that legislative purpose on its head by rewarding taxpayers which locate job-creating activities outside of Michigan and penalizing those increasing employment within the State.

IV. *A prompt resolution of this issue is critical for efficient administration of the Single Business Tax Act.*

The *J&L* decision prompted a flood of refund claims by out-of-state companies. The most recent available data reveal:

1. 296 lawsuits are pending in the Tax Tribunal, Court of Claims, and Court of Appeals involving *J&L* type claims and new lawsuits are constantly being filed.

2. Many other taxpayers have had refund claims denied by the Treasury Department, but have not yet filed suit.

3. Numerous other taxpayers have simply filed SBT returns using the *J&L* rationale, without seeking permission in advance from the Department of Treasury.

4. The total dollar value of the refund claims now in litigation already is $96,104,625, exclusive of interest.

5. Robert A. Bowman, State Treasurer, testified before the Michigan Senate Finance Committee that application of the *J&L* rationale in computing the SBT liability of 19 major Michigan-based taxpayers would result in assessments exceeding $350 million.

This deluge of refund claims and litigation not only threatens the viability of the State's budget, but has imposed a tremendous burden on Michigan's Treasury, its counsel and the court system in attempting to deal with the volume of claims.

There are approximately 7,000 multi-state taxpayers doing business in Michigan who use apportionment in computing their SBT liability. If *J&L* is good law and if the rationale of that case may be extended as suggested by the Treasury in its lawsuit against GM, then the SBT tax liability for the majority of those 7,000 multi-state taxpayers must be recomputed; either upward, in the case of GM and other firms having a significant portion of their work force in Michigan, or downward, in the case of AMP Incorporated and other firms which have a relatively small percentage of their workforces in Michigan.

Thus, wholly apart from the highly significant budgetary and business climate considerations discussed above, *J&L* is an administrative nightmare. If *J&L* was correctly decided and if its attribution method is mandated on constitutional grounds, the Treasury must proceed immediately to compute and issue either refunds or assessments covering several tax years to thousands of taxpayers. The Treasury, however, firmly believes that *J&L* is not good law. Clearly, the Treasury and the state's taxpayers need immediate guidance from the Michigan Supreme Court in this critical issue.

V. *The controlling legal issue.*

In deciding *J&L*, *AMP* and related cases, the courts have focused primarily on a comparison of two figures.

1. "Apportioned compensation," which represents the taxpayer's total compensation both within and without Michigan, multiplied by the statutorily determined percentage; and

2. "Actual Michigan compensation," which in reality is simply the taxpayer's total compensation multiplied by the Michigan wage factor.[5]

In J&L, the Court of Appeals allowed a taxpayer to invoke the relief provisions of Section 69 of the Act based on a finding that the taxpayer's "apportioned compensation" was roughly 50% greater than the taxpayer's "actual Michigan compensation".[6] In *AMP* the Court of Claims granted summary disposition in favor of the taxpayer ". . . finding that application of the statutory three-factor apportionment formula against the compensation component of Plaintiff's tax base excessively attributes compensation to Michigan by more than 350% . . . ."

The pertinent facts of *AMP* are summarized in the attached Exhibit B. As shown in that Exhibit, for the five years in which the Court of Claims granted relief the taxpayer's SBT liability was reduced as follows:

	1980	1981	1982	1983	1984
SBT Liability w/o Section 69 Relief	48,195	53,952	51,846	53,462	64,151
SBT Liability with Section 69 Relief	22,158	27,301	26,763	25,721	25,969

[5] The SBT Act defines "compensation" to include such items as pension and profit sharing benefits, health insurance benefits, etc. MCL 208.4; MSA 7.558(4). The figures cited by the lower courts as "actual Michigan compensation" are Michigan wages plus fringe benefits apportioned to Michigan by use of the payroll factor. The same figure of "actual Michigan compensation" results from multiplying total compensation by the Michigan percentage of payroll.

[6] For taxpayers based outside of Michigan which maintain a relatively small workforce here and essentially use Michigan as a market for their goods, it is not at all unusual for "apportioned compensation" to exceed by 50%, or much more, the "actual compensation" in Michigan. It is precisely because that situation is commonplace that the courts have been flooded with *J&L* type claims for refunds.

Reduction in tax	26,037	26,651	25,083	27,741	38,182
AMP's Michigan Receipts (sales)	9,912,389	10,390,067	9,819,458	11,315,584	14,779,181
AMP's SBT Liability (w/o relief) Expressed as a % of its Michigan business receipts	.4862%	.5193%	.5280%	.4725%	.4341%

The history of the relief provisions originally incorporated in the Uniform Division of Income for Tax Purposes Act (UDITPA), and as included in the SBT Act as Section 69, shows that it was intended to provide an avenue for relief from the statutory apportionment formula only in those rare and unusual instances when application of the formula produced an unreasonable or unconstitutional result.

The decisions in *J&L*, *AMP* and related cases simply are wrong because the taxpayers' *overall* tax liability in those cases was not disproportionate to the taxpayers' *overall* business activity in Michigan, and because no showing has been made by any of the involved taxpayers that their circumstances were in any way unique and unusual.

I have determined that the pending Michigan Court of Appeals' *AMP* litigation involves a controlling question of law which is of such public importance as to require an early determination by the Supreme Court. Therefore, pursuant to MCR 7.305 I am, by this Executive Message, respectfully requesting the Supreme Court to authorize the Michigan Court of Appeals to certify the following question to it for immediate determination:

In the absence of a showing by AMP Incorporated that its overall tax liability was disproportionate to its overall

business activity in Michigan, did the Court of Claims properly allow AMP to invoke the relief provisions of Section 69 of the Single Business Tax Act to reduce its SBT tax liability?

VI. *Additional relief requested.*

Because of the overriding importance of this matter to the State of Michigan, its multi-state taxpayers and the functioning of the court system, I would urge that the Supreme Court expedite the hearing on this question by scheduling an early briefing and argument date. I would also ask of this Court that it issue an order directed to the Court of Appeals, Court of Claims and Michigan Tax Tribunal ordering each of them to entertain and grant where appropriate motions for stays of proceedings in all cases involving the issue here involved. A current list of the cases now before the lower forums is attached hereto as Exhibit C.

Respectfully submitted,

/s/ James J. Blanchard
JAMES J. BLANCHARD,
Governor

November 6, 1987

STATE OF MICHIGAN
IN THE CIRCUIT COURT
FOR THE COUNTY OF INGHAM

Administrative Order 1988-3

IN THE MATTER OF:
JONES AND LAUGHLIN CASES

At a session of said Court held in the City of Lansing, Ingham County, Michigan, on the 4th day of March, 1988.

Present: Honorable MICHAEL G. HARRISON, Chief Judge

There pending in the Court of Claims in excess of 200 matters relating to what have become known as "Jones and Laughlin" type cases and the Michigan Court of Appeals having certified a conflict to the Michigan Supreme Court in its recent decision of *Trinova Corp* v *State of Mich*, —— Mich App ——, (1988),

IT IS HEREBY ORDERED that all such matters are held in abeyance pending a determination by the Supreme Court on the application for leave to appeal in *Trinova*.

IT IS FURTHER ORDERED that all such matters be removed from the active case load of the Court of Claims until further order.

/s/ Michael G. Harrison
MICHAEL G. HARRISON
Chief Circuit Judge

(2)

Supreme Court, U.S.
FILED
FEB 12 1990
JOSEPH F. SPANIOL, JR.
CLERK

No. 89-1106

IN THE SUPREME COURT
OF THE UNITED STATES

October Term, 1989

TRINOVA CORPORATION,

Petitioner,

v

STATE OF MICHIGAN,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE MICHIGAN SUPREME COURT

BRIEF IN OPPOSITION

FRANK J. KELLEY
Attorney General

LOUIS J. CARUSO
Solicitor General
Counsel of Record
525 West Ottawa Steet
Lansing, Michigan 48913
(517) 373-1124

RICHARD R. ROESCH
Assistant Attorney General
Attorneys for Respondent

Supreme Court, U.S.
FILED
FEB 12 1990
JOSEPH F. SPANIOL, JR.
CLERK

QUESTION PRESENTED

Whether this Court should review the decision of the Michigan Supreme Court which found that the three-factor apportionment formula was a constitutionally acceptable attribution method for a tax imposed upon a unitary multistate business for the privilege of doing business and measured by modified value added?

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OPINIONS BELOW

The Opinion of the Michigan Supreme Court is reported at 433 Mich 141, 445 NW2d 428 (1989), and is reproduced in Petitioner's Appendix, pp 1a-28a. The Order of the Michigan Supreme Court denying rehearing is reported at 433 Mich 1203 (1989), and is reproduced in Petitioner's Appendix, p 29a. The Opinion of the Michigan Court of Appeals is reported at 166 Mich App 656, 421 NW2d 258 (1988), and is reproduced in Petitioner's Appendix, pp 30a-41a. The Opinion and Order of the Michigan Court of Claims is unreported and reproduced in Petitioner's Appendix, pp 42a-51a.

JURISDICTION

The Michigan Court of Claims issued its Opinion and Order on May 5, 1987. Petitioner filed a timely Claim of Appeal with the Michigan Court of Appeals which issued its decision on February 22, 1988. Timely application for leave to appeal was filed with the Michigan Supreme Court which entered its Opinion and Judgment on August 21, 1989. Petitioner's timely petition for rehearing was denied by the Michigan Supreme Court on October 16, 1989.

Petitioner invokes the jurisdiction of this Court to review the Opinion and Judgement of the Michigan Supreme Court under 28 USC § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Petitioner raises constitutional challenges to the Michigan Single Business Tax Act by invoking the Due Process Clause of the United States Constitution, Amendment XIV, § 1 and the Commerce Clause of the Constitution, Article I, § 8, Clause 3. Relevant and challenged provisions of the Michigan Single Business Tax Act, MCL 208.1 et seq; MSA 7.558(1) et seq, are reprinted in Petitioner's Appendix, pp 59a-62a.

STATEMENT OF CASE

Michigan's single business tax, effective Januuary 1, 1976, replaced seven taxes upon business[1]. It also exempted persons subject to the single business tax from the specific tax imposed on intangible personal property by 1939 PA 301; MCL 205.131 et seq; MSA 7.556(1) et seq.

Corporations engaged in manufacture and sale of products became subject to a single tax for the privilege of doing business. Prior to 1976 they were sub-

[1]The domestic building and loan and savings and loan privilege tax; the foreign building and loan and savings and loan privilege tax; the federal savings and loan privilege tax; the domestic insurance company privilege tax; the financial institution income tax; the corporate income tax and the annual corporation privilege (franchise) tax.

jected to an annual franchise tax measured by their capital and surplus, i.e. their net worth, an income tax measured by federal taxable income with some modifications, and a property tax upon their intangibles, mainly stock portfolios and accounts receivable.

Each of these revenue measures, the net worth franchise tax, the income tax and the intangible property tax contained a three-factor apportionment formula of property, payroll and destination sales. Michigan's portion of a multi-state corporation's net worth, income or intangible property was computed by addition of the Michigan percentages of a taxpayer's property, payroll and sales and dividing the aggregate by 3, the number of factors.

The single business tax which was substituted for these three separate taxes, retains the identical apportionment formula. While theoretically imposed upon value added, it is "a tax upon business activity" and "its intended effect is to impose a tax upon the privilege of conducting business activity within Michigan", (Opinion of Michigan Supreme Court, Petitioner's Appendix, p 10a).

The tax base of a value added tax is computed either by subtraction of the cost of purchases (other than labor and capital items) from gross receipts OR the addition of payments for labor, borrowed capital, other production expenses and profits. The subtraction and addition method of tax base computation is

discussed in a 1984 US Treasury Department report on value-added taxation entitled "Tax Reform for Fairness, Simplicity and Economic Growth--Value-Added Tax:[2]

> "Though value added is equal to the difference between a firm's sales and its purchases, it also is equal to the payments for the labor and capital that generate the value added. Under the addition method, a firm's value-added tax liability is calculated adding together the components of value added, wages, rent, interest, and net profit and then applying the tax rate to tnat sum."

The Michigan Supreme Court likewise notes (Petitioner's Appendix, p 10a):

> "Value added, or business activity, is subject to calculation by two equivalent methods. The first method begins with a taxpayer's gross receipts from which all outside purchases are subtracted. The resi-

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[2]This report was reproduced as CCH Standard Federal Tax Reports No. 56, December 27, 1984.

dual figure represents the value added by the internal operations of the taxpayer. The second method is additive. All internal payments representing factors of production such as wages, rent, interest, together with the taxpayer's profit are totaled and constitute the value added by the taxpayer's efforts. The act employs a modified additive method of value added computation. Mobil Oil Corp v Department of Treasury, 422 Mich 473, 495-497; 373 NW2d 730 (1985)."

For a multistate taxpayer, the tax base of value added reflects the multistate taxpayer's operations both within and without Michigan. To determine the fraction of the total or universal tax base of such taxpayer which should be subject to Michigan tax the standard three-factor apportionment formula is employed. The resulting Michigan tax base is then ultimately used to compute the taxpayer's single business tax liability.

In 1985, the Michigan Court of Appeals handed down Jones & Laughlin Steel Corp v Department of Treasury, 145 Mich App 405, 377 NW2d 387 (1985), lv den 424 Mich 895 (1986) (Petitioner's Appendix, pp 63a-72a). As noted by the Michigan Supreme Court, the Jones & Laughlin Court "ruled that when any element of the taxpayer's business activity as reflected in its tax base is shown to be inaccurately represented" (Petitioner's Appendix, p 15a) the taxpayer is entitled to relief from statutory apportionment.

In Jones & Laughlin, the Michigan Court of Appeals approved a taxpayer-devised hybrid formula which allocated compensation to the geographic jurisdiction of employment and apportioned the

remaining elements of value added. In short, the taxpayer was allowed to compute its Michigan tax base by apportioning, as provided by statute, all elements of its tax base except compensation, and then simply plugging in compensation paid in Michigan.

Scores of multistate taxpayers which employed a majority of their workforce outside the State of Michigan petitioned for a refund of taxes upon the basis of the Jones & Laughlin decision. They sought recomputation of their taxes pursuant to the "Jones & Laughlin formula". Additionally, many taxpayers demanded "geographic accounting" not only for "compensation", but also for the depreciation (and in some cases interest and royalty) expense. Many taxpayers simply

filed single business tax returns upon such basis. The State refused to accept the Jones & Laughlin rationale. As a consequence, over 400 lawsuits are being contested in the Michigan courts.

On February 22, 1988, the Michigan Court of Appeals issued its Opinion in Trinova, (Petitioner's Appendix, pp 38a-41a). The three-judge panel of Trinova rejected the rationale and rule of Jones & Laughlin. Upon appeal, the Michigan Supreme Court affirmed (Petitioner's Appendix, pp 1a-28a).

ARGUMENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Petitioner argues that the Due Process and Commerce Clauses prohibit the employment of the standard three-factor apportionment formula to measure a state's portion of the value added by a multistate enterprise. It bases this argument upon the premise that value-added is not an indivisible alloy created by fusion of factors representing business activities which add to the cost of a product but is instead an aggregate of distinct components.

In essence, Petitioner postulates that Michigan's Single Business Tax Act imposes a series of taxes, upon compensation, depreciation, interest expense, royalty expense, i.e. upon each enu-

merated element of the tax base. Since most of these elements are capable of geographic accounting, are locale-specific, Petitioner insists that the Due Process and Commerce Clauses require that, for tax purposes, they be allocated. Petitioner recognizes, however, that the profit or income component of value added should be apportioned.

Thus, Petitioner concludes that it is constitutionally entitled to compute its single business tax, a value added tax, by a hybrid attribution method, combining geographic accounting (allocation of compensation and depreciation expense) and formulary apportionment of the remaining components of the tax base.

We reject Petitioner's premise. Value added is an indivisible concept, a

seemless whole incapable of precise allocation. It is generated by the totality of activities of a unitary business of manufacture and sale of products. It is not realized until the product is sold. This proposition is true regardless of the methodology of tax base computation.

If value added is computed by subtraction of a firm's purchases from its sales, great difficulty is encountered in an attempt to identify the components, elements or sources of the value added tax base. The addition method eliminates this difficulty by quantifying the different components which are fused into value added.

It remains true, however, that absent a market for its products, a manufacturer such as Trinova cannot generate value

added. It has no positive or negative income which is the starting point in the computation of the single business tax base under the addition method. Without a market for its product, Trinova has no gross receipts from sale, which is the starting point in computing value added pursuant to the subtraction method.

In Bass, Ratcliff & Gretton v State Tax Commission, 266 US 271, 282 (1924), this Court stated:

> "So in the present case we are of the opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions, beginning with the manufacture in England and ending in sales in New York and other places, the process of manufacturing resulting in no profits until it ends in sales, the state was justified in attributing to New York a just proportion of the profits earned by the company from such unitary business. In Wallace v Hines, 253 US 66, 69, 64 LEd 782, 786, 40 SupCt Rep 435, it was recognized that

a state in imposing an excise tax upon foreign corporations in respect to doing business within the state, may look to the property of such corporations beyond its borders to 'get the true value of things within it, when they are part of an organic system of wide extent,' giving the local property a value above that which it would otherwise possess, and may therefore take into account property situated elsewhere when it 'can be seen in some plain and fairly intelligible way that it adds to the value of the property and the rights exercised in the state.' This is directly applicable to the carrying on of a unitary business of manufacture and sale partly within and partly without the state."

The foregoing observation is applicable to value added by Petitioner. Trinova carries on a unitary business in which it generates value added by a series of transactions ending in sales in Michigan and elsewhere--and the process of manufacture results in no value added until it ends in sales.

Petitioner recognizes that values generated by unitary enterprise of a multistate business may be apportioned by formula to the states wherein the unitary business is conducted. "The lynchpin of apportionability ... is the unitary-business principle." Mobil Oil Corp v Commissioner of Taxes, 445 US 425, 439 (1980).

"Having determined that a certain set of activities constitute a 'unitary business', a State must then apply a formula apportioning the income of that business within and without the State. Such an apportionment formula must, under both the Due Process and Commerce Clauses, be fair." Container Corporation of America v Franchise Tax Board, 463 US 159, 169 (1983).

This Court continued:

"The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency--that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed. The second and more difficult requirement is what might be called external consistency--the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."

The Michigan Supreme Court tested the single business tax imposed upon Trinova by the requirements of internal and external consistency. It noted that Trinova did not contest the internal consistency of the Single Business Tax Act's apportionment formula (Petitioner's Appendix, pp 18a, 19a). It concluded that "the averaged ratios of Trinova's payroll, property, and sales 'actually

reflect a reasonable sense of how [its Michigan business activity was] generated,' clearly satisfying the constitutional requirements of internal and external consistency" (Petitioner's Appendix, p 25a).

Petitioner, however, characterizes the single business tax as "a tax on compensation" (Petition, p 19). It argues that compensation, depreciation and other "inputs of added value .... With the exception of profit" (Petition, p 19) must be allocated to their source. Petitioner insists that they "should not be apportioned at all ... because the value added by those components is capable of precise location inside and outside the state" (Petition, p 15).

The plain answer to such assertions is that the single business tax, by

statutory profession and judicial interpretation," is a tax upon business activity" and "its intended effect is to impose a tax upon the privilege of conducting business activity within Michigan" (Petitioner's Appendix, p 10a). It does not levy a tax on compensation, depreciation, any other cost of doing business or upon income. It taxes the privilege of doing business in Michigan measured by that portion of total value added which is fairly attributable to Michigan.

The Michigan Supreme Court found that the single business tax satisfies the four-prong test enunciated by this Court in Complete Auto Transit, Inc. v Brady, 430 US 274, 279 (1977). It found that the tax was applied to an activity with a

substantial nexus with the taxing state, was fairly apportioned, not discriminatory against interstate commerce, and fairly related to the services provided by the state.

Petitioner asserts that (Petition, p 15) "The Michigan SBT as construed by the Michigan Supreme Court fails the second and third prongs of the Complete Auto test". It charges unfair apportionment and discrimination against interstate commerce.

It premises the charge of unconstitutional apportionment upon its insistence that the single business tax is imposed on extraterritorial compensation and depreciation. Thus, Trinova reiterates its disagreement with the legislative declaration and statutory construction of

the Michigan Supreme Court that the tax is imposed upon business activity fairly attributable to Michigan.

Petitioner quests for fission of value added and attribution of its fragments to geographic sources. This quest and its rationale cannot be differentiated from Shell Oil Company's contention, rejected by this Court in Shell Oil Company v Iowa Department of Revenue, 488 US ____, 109 S Ct 278 (1988), that income from outer continental shelf activities must be excluded from the pre-apportioned tax base of Iowa's income tax. Values adhering to or produced by unitary activities of a farflung enterprise cannot be assigned to a geographic, Mobil Oil Corporation v Commissioner of Taxes, supra, or func-

tional source, Exxon Corporation v Wisconsin Department of Revenue, 447 US 207 (1980). In Amerada Hess Corporation v New Jersey Department of the Treasury, 490 US ____, 109 S Ct 1617 (1989), this Court rejected the contention that an expense or cost of a unitary business--in that case the windfall profits tax--can be geographically assigned.

Trinova's insistence that the State of Michigan must geographically assign an integral portion of value added, compensation costs and depreciation expense, to the place where these costs are incurred is directly rejected by Amerada Hess, supra, and indirectly, but with equal force, by Mobil Oil Corporation, supra, Exxon, supra, Shell Oil Company, supra, and Container Corporation, supra. The

pre-apportioned tax base of value-added, in order to be meaningful, must include all of the costs, including compensation and depreciation expense regardless of where it is incurred. This tax base, after apportionment by the three-factor formula, characterized as a benchmark in Container, results in taxation of those activities which are fairly related to the advantages provided to Trinova's business by the State of Michigan.

Petitioner argues that the three-factor formula is a benchmark only for attribution of multistate income; that it does not yield a constitutionally acceptable result when applied to value added by a multistate enterprise. It argues (Petition, pp 22, 23) that the sales factor must be eliminated, leaving a two-factor formula of property and payroll.

Whatever theoretical justification may be offered in support of such formula, it has never been adopted by any jurisdiction to measure the income, net worth or property of a multistate business. As noted previously, the single business tax replaced taxes on corporate income, net worth and intangible properties which were attributed to the state, when they arose from or were connected with unitary activities of a multistate enterprise, by the standard three-factor formula.

In 1980, Trinova marketed nearly $104,000,000 of its products in Michigan. The Single Business Tax Act levied an exaction for Trinova's privilege of doing business in Michigan amounting to $293,528. Trinova's tax liability was

consequently less than 3/10 of 1% of gross receipts from its Michigan sales, imposed by a single exaction which replaced exactions on income, net worth and intangible property. In Moorman Manufacturing Company v Bair, 437 US 267, 280-281 (1978), this Court noted that "Appellant's actual income tax was the rough equivalent of a 1% tax on the entire gross receipts from its Iowa sales."

Nothing can obscure the fact that elimination of compensation and depreciation expenses from the pre-apportioned tax base of Trinova and its geographic allocation yields no tax whatever, but results in a negative tax base which can be carried over to other tax years. Trinova's computation of its tax base for

1980 results in a loss carry-over of nearly $28,000,000 computed as follows:

business income (loss)	$(42,466,114)
~~add: compensation~~	~~226,356,271~~
~~depreciation~~	~~23,262,909~~
dividends, interest, royalties paid	22,908,950
other	549,526
subtotal	~~230,611,542~~ (19,007,638)
deduct: dividends, interest, and royalties received	9,486,223
~~Section 9 tax base~~	~~$221,125,319~~ (28,493,861)
Plus:	
Allocated Michigan compensation	511,774
Allocated Michigan depreciation	2,152
Trinova-computed tax base	(27,979,935)

Trinova's assertion that the three-factor apportionment formula amounts to economic protectionism and discriminates against

out-of-state business deserves but scant discussion. It is erroneously premised on the geographic attribution of compensation and depreciation expenses. Such faulty premise leads to the erroneous conclusion that the Single Business Tax Act does not tax compensation and depreciation where the workforce is employed, thus favoring Michigan employers.

The conclusion falls with its premise. The single business tax does not tax compensation and depreciation. For the privilege of doing Michigan business, it levies a tax upon modified value-added, an indivisible alloy created by fusion of profits and all the factors which add to the cost of a product. It is not realized at any particular stage of production or distribution, but is

produced by a series of unitary activities which terminates with the sale of products.

Petitioner complains of "the State's unthinking adoption of the three-part formula used to apportion income taxes." (Petition, p 21) We hasten to suggest that the three-factor apportionment formula was deliberately chosen as a measure of value added by unitary activities of a multistate business. It must be appreciated that the single business tax replaced taxes on income, net worth and intangible property, which were apportioned by identical formula. More importantly, the three-factor formula is used by a majority of states to apportion taxes imposed on multistate businesses.

In the context of general use of such three-factor approach to tax corporate

presence and activities measured by income or net worth, Michigan's single tax on multistate business, if measured by other than the three-factor formula, would ordinarily result in multiple (or partial) tax burdens for a multistate business. General Motors Corporation v District of Columbia, 380 US 553, 559 (1965).

In this case, Petitioner challenges the employment of the standard three-factor formula to value added by the unitary activities of a multistate business. This case does not involve tax credits and tax exemptions which favor local business.

Westinghouse Electric Corporation v Tully, 466 US 388 (1984), involved a credit for exports shipped from the

state; Tyler Pipe Industries, Inc. v Washington State Department of Revenue, 483 US 232 (1987), involved a tax credit for local manufacturers; Boston Stock Exchange v State Tax Commission, 429 US 318 (1977), dealt with a 50% tax reduction for sale and transfer of stock within the state; Maryland v Louisiana, 451 US 725 (1981), invalidated a natural gas tax from which in-state users were partially exempt; in American Trucking Associations, Inc. v Scheiner, 483 US 266 (1987), a commercial advantage was given to local truckers by imposition of a flat rate axle tax.

Scheiner deals with an unapportioned tax burdening interstate commerce; the other cited cases reflect geographical bias, detrimental to non-domiciliary

business, of tax exceptions and credits. These cases relied upon by Petitioner bear no resemblance and are inapposite to this case.

CONCLUSION

In Moorman Manufacturing, supra, this Court declined to interpret the Constitution to require the application of the equally weighted three-factor apportionment formula. In Container Corporation, supra, the Court referred to that formula as "something of a benchmark". Yet, Trinova asks this Court to invalidate the application of the three-factor formula to apportion value added by the unitary activities of a multistate business which is used as a measure of its privilege of doing business in Michigan.

Trinova asserts that it is entitled to geographic sourcing of elements which are fused into value added. This Court has consistently held that sourcing of

income or values arising from unitary activities is not constitutionally required, Mobil Oil Corporation, supra, Exxon Corporation, supra, Shell Oil Company, supra, Amerada Hess, supra.

Alternatively, Trinova insists that its privilege of doing business in Michigan must be measured by a two-factor apportionment formula consisting of property and payroll applied to the total value added to its products. Moorman Manufacturing, supra, dispositively holds that the Constitution does not require the use of any particular apportionment formula.

The three-factor apportionment formula of the single business tax does not discriminate against out-state businesses. It treats both local and foreign

concerns with an even hand. Trinova's "discrimination" claim vanishes with its underlying premise that the Constitution requires the "sourcing" of elements which, by unitary multistate activities, are fused into value added.

For these reasons Respondent requests that the Petition for Writ of Certiorari be denied.

Respectfully submitted,

FRANK J. KELLEY
Attorney General

Louis J. Caruso
Solicitor General
Counsel of Record
525 West Ottawa Street
Lansing, Michigan 48913
(517) 373-1124

Richard R. Roesch
Assistant Attorney General
Attorneys for Respondent

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

TRINOVA CORPORATION,
Petitioner,

v.

STATE OF MICHIGAN,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of Michigan

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PETITIONER'S REPLY BRIEF

Of Counsel:
BENJAMIN O. SCHWENDENER, JR.
ALAN M. VALADE
SCHWENDENER & VALADE, P.C.
Dart Management Building
Mason, Michigan 48854
(517) 676-5137

WILLIAM F. SHEEHAN
COLLETTE C. GOODMAN
SHEA & GARDNER
1800 Massachusetts Ave., N.W.
Washington, D.C. 20036
(202) 828-2000

WALTER HELLERSTEIN
Professor of Law
University of Georgia
School of Law
Athens, Georgia 30602
(404) 542-5175

PETER S. SHELDON
(Counsel of Record)
THOMAS D. HAMMERSCHMIDT, JR.
JEFFERY V. STUCKEY
DICKINSON, WRIGHT, MOON,
VAN DUSEN & FREEMAN
215 S. Washington Square
Lansing, Michigan 48933
(517) 371-1730

Counsel for Petitioner

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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PETITIONER'S REPLY BRIEF

The State's Brief in Opposition revives an approach to the Commerce Clause that this Court has rejected. It asks the Court to forego economic analysis in reliance on assurances from the State that the SBT taxes "business activities" or "the privilege of doing business." It ignores, and counsels the Court to ignore, "the practical effect of [the] challenged tax". *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 443 (1980). The outcome here will affect not only petitioner but also several hundred other multistate corporations with over 400 pending cases in Michigan. (Opp. 11.) These cases should be resolved not by labels but on constitutional principles that recognize economic realities. *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 279 (1977).

I. THE SBT APPORTIONMENT SCHEME TAXES EXTRATERRITORIAL VALUE

1. The State has conceded that a direct tax on compensation would require specific allocation to the state in which the compensation was paid;[1] that compensation accounted for *all* of petitioner's tax base under the SBT (Pet. App. 54a); and that the compensation apportioned by the SBT to Michigan overstated actual Michigan compensation by nearly 40 times. (*Id.*) A confession should follow that the result is unconstittuional.

Instead the State suports the tax by ignoring the components the statute itself identifies—compensation, capital costs, and profit—and by asserting that the SBT taxes "an indivisible alloy created by fusion" of those components. (Opp. 12; see *id.* 28.) The "indivisible alloy" concept is obviously meant to put a value added tax in the same category as an income tax so as to justify the SBT's use of the traditional three-factor formula for apportioning income. The same objective is behind the State's assertion that "[v]alue added is an indivisible concept, a seemless [sic] whole incapable of precise allocation" (Opp. 13-14). But there the argument stops. The State never explains why value added is indivisible, and in fact it is not—as the statute itself demonstrates by identifying compensation, capital costs, and profit as the elements of value added.[2] Indeed, in its stipulation

[1] See Pet. 12, quoting the State's acknowledgement in the Michigan Supreme Court that a tax on compensation "would apply to a tax subject so inherently locale-specific as to require specific allocation." In this Court as well the State concedes that compensation and capital costs "are capable of geographic accounting, are locale specific." (Opp. 13.)

[2] See SBT § 9; Pet. App. 10a-12a. As the State recognizes, any value added tax using the additive method, as the SBT does, "eliminates th[e] difficulty" in "identify[ing] the components, elements or sources of the value added tax base." (Opp. 14.)

to the makeup of petitioner's tax base the State identifies the same components. (See Pet. App. 54a.)[3]

Nothing is added to the "indivisible alloy" concept by the State's repeat of the Michigan Supreme Court's view that the SBT "is a 'tax on business activity'" or "'a tax upon the privilege of conducting business activity in Michigan.'" (Opp. 6, 19-20.) These words tell us nothing, as the Court has recognized.[4] What is more telling is the State's acceptance of our description of the tax as one laid upon the value added by the taxpayer to the raw materials or products it purchases, and one measured by the contributions of the labor of its employees, the capital of its owners, and the skill of its managers. (Opp. 6-8.) Those components of the tax base define the

[3] The State's contention that "the process of manufacture results in no value added until it ends in sales" (Opp. 16), does not support its "indivisibility" argument and is wrong to boot. The SBT is a consumption-type tax, meaning that value is added by the consumption of labor and capital in the course of the product's manufacture and sale. Thus compensation will have been paid, and the wages entered into the community's economic stream, before the product even reaches the retail shelf. "The value of the labor used in production * * * is the wages paid to the laborer, and the income the worker receives for providing labor to the economy." *Mobil Oil Corp.* v. *Department of Treasury*, 422 Mich. 473, 494, 373 N.W.2d 730, 740 (1985).

Indeed, while the manufacturing process obviously comtemplates that the products will be sold, the unapportioned tax base is only trivially affected by the net income or loss from those sales. Lower sales mean lower profits but, as we have already shown, the SBT taxes value added primarily by compensation and depreciation, which are largely unaffected whether the taxpayer makes a profit or a loss. In short, "[a] value added tax taxes economic activity itself." *Wismer & Becker* v. *Department of Treasury*, 146 Mich. App. 690, 696, 382 N.W.2d 505 (1985).

[4] See *American Trucking Ass'ns* v. *Scheiner*, 483 U.S. 266, 294-295 (1987) ("In our more recent decisions we have rejected this somewhat metaphysical approach to the Commerce Clause that focused primarily on the character of the privilege rather than the practical consequences of the tax.").

tax, whether one calls it a tax on value added, or on business activity, or on an indivisible alloy. "A tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes."[5] So a tax on business activity measured by compensation is a tax on compensation.

2. The tax is not saved by its pedigree. (See Opp. 5-6.) Michigan's predecessor property, net worth, and income taxes may well have been lawful, and the SBT may "retain[] the identical apportionment formula" they used, but that is irrelevant to the constitutional question whether Michigan, having decided to impose a value added tax, has adopted a method that incorrectly assigns to Michigan a grossly excessive part of that added value almost all of which was, in fact, added outside rather than inside the State.

3. Nor is it relevant that this Court has upheld formulas for apportioning among several states the corporate income of a unitary business. (Opp. 16-24.) The key to those decisions is the infeasibility of identifying, on a geographic basis or through separate cost accounting, the contributions of corporate activities in each of several states to the overall net income of a unitary business. *E.g., Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159, 180-184 (1983). That principle has led the Court to reject contentions that certain specific contributions to *income* could be identified, separately allocated, and eliminated from the tax base. *E.g., Exxon Corp.* v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980). But those decisions are inapposite here because formulary apportionment and the unitary business principle upon which it rests are inappropriate where the tax base is precisely identifiable on a geographic basis.

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[5] *State Taxation of Interstate Commerce*, 27 Tenn. L. Rev. 239, 242 (1960).

Even if it were appropriate to apply the unitary business principle, this Court has not hestitated to invalidate the application of apportionment formulas when they result in the taxation of extraterritorial value.[6] As the Court has declared:

> "The only reason for allowing a state to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it, when they are part of an organic system of wide extent, that gives them a value above what they otherwise would possess. The purpose is not to expose the heel of the system to a mortal dart, —not, in other words, to open to taxation what is not within the state."

Wallace v. *Hines*, 253 U.S. 66, 69 (1920).

4. Nor, finally, is it relevant that the amount of tax assessed against petitioner was modest compared to its Michigan sales or that, if petitioner's view prevails, it would have a tax loss carryover. (Opp. 25-27.)[7] Modesty is not the test of constitutionality. What matters is that virtually every dollar of tax paid by petitioner represents value demonstrably added outside Michigan and that the amount of the tax results almost entirely from an inappropriate formula.[8] A tax may survive imprecision, *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 273

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[6] *E.g., Norfolk & Western Ry.* v. *Missouri Tax Comm'n*, 390 U.S. 317 (1968); *Hans Rees' Sons, Inc.* v. *North Carolina*, 283 U.S. 123 (1931).

[7] The State errs in finding a loss carryover of nearly $28 million. That figure represents the preapportioned tax loss. After apportionment petitioner's carryover would be about $2 million.

[8] The standard three-factor apportionment formula, wholly appropriate in an income tax context in order to divide nonsource-specific business income among states jurisdictionally entitled to tax, gives the same weight to sales (which make little or no contribution to the value added tax base) as it does to payroll and property (which make significant contributions to the tax base).

(1978), but not an error which in petitioner's case is wrong by a factor of almost 40 and is likely to be comparably disproportionate in the case of most out-of-state businesses. And there is no reason why a taxpayer may not have a loss carryover under a value added tax regime if, as here, the taxpayer suffers a sizable loss and almost all of its value adding activities occur outside the taxing jurisdiction.

In sum the State prefers labels to analysis because the economic realities are against the tax. The SBT specifies the components of the tax base. The principal ones, compensation and depreciation, can be precisely identified on a geographical basis and should be specifically allocated to the state in which they occur.

II. THE SBT IS IMPERMISSIBLY DISCRIMINATORY

The State has no real response to our showing that the SBT discriminates against out-of-state businesses. It does not challenge the factual economic analysis in our petition or offer any counter-analysis of its own. It merely says what is both true and irrelevant, that this case "does not involve tax credits and tax exemptions which favor local business." But it does involve a tax that, as we demonstrated, systematically reduces the tax base for Michigan-based companies and systematically increases the tax base for out-of-state companies. The effect is not constitutionally different from a discriminatory credit or exemption. Like those devices, the SBT should be condemned for " 'providing a direct commercial advantage to local business.' " *Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. 318, 329 (1977) (citation omitted).[9]

* * * * *

[9] *Cf.* the statement of Michigan's Governor that a major purpose of the SBT was "to promote the development and investment of business *within* Michigan." (Pet. App. 79a; emphasis in original.)

The record evidence of misallocation and discrimination in this case establishes the SBT's unconstitutionality. The Michigan Supreme Court's contrary conclusion forgets that constitutional limitations on state tax power must be "measured in dollars and cents, not legal abstractions" (*Halliburton Oil Well Co.* v. *Reily*, 373 U.S. 64, 70 (1963)), and that a state tax must be "tax neutral." *Boston Stock Exchange*, 429 U.S. at 331; *Westinghouse Elec. Corp.* v. *Tully*, 466 U.S. 388, 406 (1984). Review by this Court will provide an occasion to clarify the states' ability to apply the three-factor apportionment formula, and will assure that this case, and the more than 400 others awaiting its outcome, are determined according to correct constitutional principles.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

Of Counsel:
BENJAMIN O. SCHWENDENER, JR.
ALAN M. VALADE
SCHWENDENER & VALADE, P.C.
Dart Management Building
Mason, Michigan 48854
(517) 676-5137

WILLIAM F. SHEEHAN
COLLETTE C. GOODMAN
SHEA & GARDNER
1800 Massachusetts Ave., N.W.
Washington, D.C. 20036
(202) 828-2000

WALTER HELLERSTEIN
Professor of Law
University of Georgia
School of Law
Athens, Georgia 30602
(404) 542-5175

PETER S. SHELDON
(Counsel of Record)
THOMAS D. HAMMERSCHMIDT, JR.
JEFFERY V. STUCKEY
DICKINSON, WRIGHT, MOON,
VAN DUSEN & FREEMAN
215 S. Washington Square
Lansing, Michigan 48933
(517) 371-1730

Counsel for Petitioner

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No. 89-1106

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

TRINOVA CORPORATION,
Petitioner,

v.

STATE OF MICHIGAN,
Respondent.

On Writ of Certiorari to the Supreme Court of Michigan

BRIEF FOR PETITIONER

Of Counsel:
BENJAMIN O. SCHWENDENER, JR.
ALAN M. VALADE
SCHWENDENER & VALADE, P.C.
Dart Management Building
Mason, Michigan 48854
(517) 676-5137

WILLIAM F. SHEEHAN
COLLETTE C. GOODMAN
SHEA & GARDNER
1800 Massachusetts Ave., N.W.
Washington, D.C. 20036
(202) 828-2000

WALTER HELLERSTEIN
Professor of Law
University of Georgia
School of Law
Athens, Georgia 30602
(404) 542-5175

PETER S. SHELDON
(Counsel of Record)
THOMAS D. HAMMERSCHMIDT, JR.
JEFFERY V. STUCKEY
DICKINSON, WRIGHT, MOON,
VAN DUSEN & FREEMAN
215 S. Washington Square
Suite 200
Lansing, Michigan 48933-1812
(517) 371-1730

Counsel for Petitioner

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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QUESTIONS PRESENTED

The Michigan Single Business Tax Act imposes a tax, nominally on the "privilege of doing business" within the state, measured by the "value added" by the taxpayer to the goods and services it buys. The Act's value added tax base consists of the taxpayer's labor costs (primarily wages paid to all of its employees), its capital costs (primarily depreciation and interest payments), and its profit. The Act determines the portion of this value deemed to have been added in Michigan by apportioning the tax base according to the three-factor formula of payroll, property, and sales that is widely used to apportion income under state income tax statutes.

The questions presented are:

1. Whether application to petitioner's value-added tax base of the Act's three-factor formula results in a tax on value actually added outside the state and produces a grossly distorted result, in violation of the Due Process and Commerce Clauses; and

2. Whether the Act discriminates against out-of-state businesses in favor of in-state businesses by employing an apportionment formula that, in the vast majority of cases, systematically and irrationally reduces the tax bases of the latter and increases the tax bases of the former, in violation of the Commerce Clause.

LIST OF PARTIES AND RULE 29.1 STATEMENT

Petitioner is the corporate successor to Libby-Owens-Ford Company, which commenced this action. Apart from the respondent, there were no other parties to the proceedings below. Petitioner's subsidiaries (except wholly owned subsidiaries) are these:

Aeroquip Gmbh
Aeroquip International, Inc.
Aeroquip Mexicana, S.A.
Aeroquip Vickers do Brasil, S.A.
Custom Trim of Michigan, Inc.
Korea Vickers Systems Co., Ltd.
Microfuel Systems, Inc.
Sterling INOAC Co.
Super Seals India, Ltd.
Test Systems & Simulation, Inc.
Toyo Joint Co., Ltd.
Vickers of India, Limited
Vickers Kawasaki Controls KK
Vickers Systems Gmbh
(Belgium, The Netherlands, and Switzerland)
Vickers Systems, Inc.
Yokohama Aeroquip KK

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IN THE

Supreme Court of the United States

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No. 89-1106

TRINOVA CORPORATION,
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v.
STATE OF MICHIGAN,
Respondent.

On Writ of Certiorari to the Supreme Court of Michigan

BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the Supreme Court of Michigan (Pet. App. 1a-28a) is reported at 433 Mich. 141, 445 N.W.2d 428 (1989). The order of the Supreme Court of Michigan denying rehearing (Pet. App. 29a) is reported at 433 Mich. 1203 (1989). The opinion of the Michigan Court of Appeals (Pet. App. 30a-41a) is reported at 166 Mich. App. 656, 421 N.W.2d 258 (1988). The opinion and order of the Michigan Court of Claims (Pet. App. 42a-51a) is not reported.

JURISDICTION

The judgment of the Supreme Court of Michigan was entered on August 21, 1989. Petitioner's timely petition for rehearing was denied on October 16, 1989 (Pet. App. 29a). The petition for a writ of certiorari was filed on January 16, 1990 and was granted on March 5, 1990.

The jurisdiction of this Court rests upon 28 U.S.C.A. § 1257(a) (West Supp. 1990).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Due Process Clause of the Constitution, Amend. XIV, § 1 provides: "[N]or shall any State deprive any person of life, liberty, or property, without due process of law."

The Commerce Clause of the Constitution, Art. I, § 8, cl. 3, provides that Congress shall have Power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

Relevant portions of the Michigan Single Business Tax Act, Mich. Comp. Laws §§ 208.1-208.136 (1979), are set forth at Pet. App. 59a-62a.

STATEMENT OF THE CASE

Prior to 1976, the primary business taxes imposed by the State of Michigan were a corporate income tax, a franchise tax, a personal property tax on inventories, an intangible business tax, a financial institutions tax, an insurance company privilege fee and a savings and loan tax. These business taxes were all repealed and were replaced in 1976 by the Michigan Single Business Tax.

The Michigan Single Business Tax ("Act" or "SBT") is a form of what is generally referred to as a value added tax. Although value added taxes have been widely adopted in Europe and other countries, and there has been considerable discussion about their possible adoption in this country both at the federal and state levels, Michigan is the only state that has thus far done so.

Various aspects of state tax systems based on the "unitary business" principle and formulary apportionment have provoked repeated constitutional litigation in this Court. *E.g., Container Corp. v. Franchise Tax*

Board, 463 U.S. 159, 163-64 (1983). So far as we know, however, the Court has never considered a value added tax. This kind of tax is uncommon in this country. Thus it may be useful, before describing the SBT, to start with a discussion of the structure of value added taxes generally.

A. The Nature Of A Value Added Tax

In broad terms, a value added tax ("VAT") is a "levy based on the value added at each step in the production and distribution of a commodity or service, from the earliest stage up through the final retail sale," Note, *Value-Added Taxation: Its Concepts and Effects*, 39 U. Cin. L. Rev. 331, 333 (1970), citing Tax Foundation, Inc., *Federal Non-Income Taxes—An Examination of Selected Revenue Sources* 52 (Research Publication No. 1 New Series, 1965), or a tax on "the increase in the value of goods and services brought about by whatever a business does to them between the time of purchase and the time of sale." Haughey, *The Economic Logic of the Single Business Tax*, 22 Wayne L. Rev. 1017, 1018 (1976). Put yet another way, a VAT is a "tax levied on businesses on the value they add to their purchases of raw materials and goods and services." A. Tait, *Value Added Tax* 2 (1972); Cambridge Research Institute, *What You Should Know About The Value Added Tax* 3 (1973).

The tax may be most easily understood if it is assumed to have been adopted by a state to apply to a taxpayer that adds all the value to its product within the taxing state. With respect to the final product or service that is delivered to the ultimate consumer, portions of the value of that product or service are contributed by each of the enterprises in the chain of businesses through whose hands it passes in the course of production. Each enterprise purchases raw materials or goods from other enterprises in the chain, and then adds value to those inputs through the use of labor, capital, and the con-

tribution of its entrepreneurial effort. The value of its labor is measured by the costs incurred for compensation to workers. The value of its capital is measured by the costs incurred for interest, depreciation, and rent. The value of its entrepreneurial effort is measured by its profit when it sells the product or service.

For example, the steps in the production of a loaf of bread to the point of its retail sale to the ultimate consumer will involve, first, the transaction by which a farmer sells wheat to a miller. If we assume that the price paid by the miller to the farmer is $.12, the value added by the farmer's efforts is measured by that amount.[1] The miller, in turn, will convert the wheat into flour through the work of its employees and the use of its plant and equipment. If the payments for the use of such labor and capital are, say, $.14 and $.03, respectively, and the miller's profit is $.01, then the baker who purchases the flour from the miller will pay $.30.

This process will continue when the baker processes the flour into a loaf of bread for sale to a wholesale grocer, when the wholesale grocer packages the loaf of bread and sells it to a retail outlet, and when the retailer sells the packaged loaf of bread to the ultimate consumer. Each of these enterprises—the baker, the wholesale grocer, and the retailer—will also add value to the final product, measured, in varying quantities, by each enterprise's expenditures for labor, capital, and its entrepreneurial profit. *See* Smith, *Value-Added Tax: The Case For*, Harv. Bus. Rev., Nov.-Dec. 1970, at 77, 78, adopted from "Where's the Money Coming From," Forbes, Feb. 15, 1970, at 10.[2]

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[1] We also assume, for simplicity's sake, that the farmer has no costs for seeds or supplies.

[2] Taxation rarely is simple, and here complexities arise from the fact that there are different types of VATs, such as the so-called gross product, net income, and consumption types. *See* C. Sullivan, *The Tax on Value Added* Ch. 1 (1965); R. Kleine, *The Michigan Single Business Tax: A Different Approach to State Business*

Note that in this simplified example, the value added by each taxpayer in the chain can be determined either by adding the three elements that contribute to the value of the finished product—labor, capital, and profit—or by subtracting from the sales price the amount paid for raw materials. The literature describes these calculations as the "addition" method and the "subtraction" method. They are the two basic methods for calculating a taxpayer's value added.[3] "The results of either method are necessarily identical since subtracting purchased goods and services from total sales leaves labor cost, profit or loss, interest paid and depreciation charges—the internal payments to the factors of production that created the added value." Haughey, *supra* p. 3, at 1018-19.

B. Treatment Of Interstate Transactions

The foregoing discussion assumed goods produced and sold in a single jurisdiction. But when goods are

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Taxation 5, Advisory Commission on Intergovernmental Relations (March 1978), Cambridge Research Institute, *supra* p. 3, at 6. The difference in these types lies in the way in which they treat capital expenditures.

The Michigan SBT is a consumption-type tax using the additive method, as we explain below. Speaking generally, such a tax measures the contribution of capital investment to the value of a product by the amount of depreciation and amortization of the plant and equipment owned by the taxpayer, plus the interest and rent paid for the capital hired by the taxpayer. It is called a consumption-type tax because the value added by the use of owned capital equipment is taxed only as the equipment is consumed in the production process. *See* Shoup, *Theory and Background of the Value-Added Tax*, Proceedings of the Forty-Eighth Annual Conference on Taxation of the National Tax Association, 6, 9 (1955). The SBT adopts the view that for such a tax the tax base must be reduced, in the year in which a capital asset is acquired, by the cost of that asset, in order to avoid double taxation of the capital asset, first upon the producer of the asset, then upon the user. Haughey, *supra* p. 3, at 1027.

[3] Thus, in the case of the miller, the value added, $.18, is both the sum of $.14, $.03, and $.01 (using the addition method), and the difference between $.30 and $.12 (using the subtraction method).

produced partly in several jurisdictions and sold in several jurisdictions, one must decide whether to tax the value added where the goods are consumed or where they are produced. McLure, *State and Federal Relations in the Taxation of Value Added*, J. Corp. L., Fall 1980, at 127, 128. The European VATs with which most people are familiar employ the so-called "destination" principle, meaning that the VAT is imposed where the goods are consumed. The tax is imposed on all imports coming into the taxing jurisdiction, while all exports are sold free of tax.[4] Thus, the European VATs operate very much like retail sales taxes in the United States, except that some part of the tax is collected at each stage in the production chain. But, like a retail sales tax, the ultimate burden of the tax falls on the consumer, and the revenue from the tax benefits significantly the jurisdiction in which the consumer resides.

The alternative to the destination principle is the origin principle, under which the tax is imposed on the value added through the production of the goods *within* the taxing jurisdiction. Hence exports are taxed; imports are not. Oldman & Woods, *Would a Value-Added Tax System Relieve Tax Compliance Problems*, International Conference on Income Taxation, 1983 A.B.A. Sec.

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[4] The system is implemented in the European countries through a system of credits. Each taxpayer charges its purchasers a VAT calculated by multiplying the selling price of its goods by the applicable rate of tax. From the aggregate amount of tax it charges its customers, the taxpayer deducts the amount of VAT shown on the invoices for the goods it purchased from other firms. The net result is what the taxpayer owes the government. Hence, the tax is passed on by each firm in the chain of production to the next one until it is collected by the retailer from the final consumer, who ultimately bears the burden of the tax.

If the sales made by the firm are export sales—*i.e.*, destined for outside the taxing jurisdiction—no tax is imposed. The firm may still claim a credit for the VAT it paid on its purchases, meaning that no tax is imposed on export sales. Conversely, imports are taxed fully when they enter the country.

of Tax'n, 329 and 336 at n.79. *See* Laffer, *The International Impact of a Value-Added Tax*, J. Corp. L., Fall 1980, at 119, 119-120 ("[t]he origin principle of taxation . . . taxes all domestic value added irrespective of the location of the consumer or investor."); A. Tait, *supra* p. 3, at 16-17; Krauss and O'Brien, *Some International Implications of Value-Added Taxation*, Nat'l Tax J., Vol. XXIII, No. 4, 435, 436 (1970). Indeed, under the origin principle, the tax may be imposed on products that have been added to inventory even if there is no consumer at all. For example, if 80% of a manufacturer's products are sold, the labor and capital costs attributed to the unsold 20% are nevertheless included in the manufacturer's tax base.

Thus, the primary difference between a destination principle VAT and an origin principle VAT is the jurisdiction that reaps the tax benefit—the purchaser's jurisdiction in the case of the former, the producer's jurisdiction in the case of the latter.

While a destination principle value added tax is the commonly accepted approach in the context of international trade, experts have concluded that for practical reasons it would be virtually impossible to employ the destination principle at the state level in the United States.

> It is almost universally assumed that Congress, if it were to adopt a VAT, would follow standard practice and impose a destination-principle VAT, rather than origin-principle tax. That is, the tax would be rebated on American exports, but applied to imports. *The analogous approach would be quite unlikely, however, for interstate sales under state value added taxes. One can hardly imagine the construction of the fiscal frontiers between states that would be necessary for the collection of destination-based state value added taxes. Rather, it seems almost inevitable that state value added taxes would be based on the origin principle for interstate sales.*

McLure, *supra* p. 6, at 130-131 (emphasis supplied).

As we will see below, the SBT follows the additive approach. The American Bar Association Section of Taxation, which has extensively studied the possible use of VATs in the United States, has concluded that an additive VAT would almost certainly have to operate on the origin principle:

> [A]s a practical matter, an additive method VAT at the state level would have to be designed on an origin rather than destination principle; that is, tax would not be imposed on imports and tax would not be rebated on exports. The tax revenue would inure to the benefit of the state in which the productive activity occurred.

Evaluation of an Additive-Method Value-Added Tax for Use in the United States, Fifth Report of the Special Committee on Value-Added Tax, A.B.A. Sec. of Tax'n, 30 Tax Lawyer 565, 566 (1977) (footnote omitted).[5]

We turn now to a description of Michigan's SBT, and its actual effect on out-of-state taxpayers.

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[5] *See also, The Choice Between Value-Added and Sales Taxation at the Federal and State Levels in the United States*, Fourth Report of the Special Committee on the Value-Added Tax, A.B.A. Sec. of Tax'n, 29 Tax Lawyer 457, 465 (1976):

> In practice, the destination principle and the addition or subtraction method are mutually inconsistent. A vendor will collect the tax by adding it to the sales price. This is practical only so long as the tax is a simple percentage of the price otherwise charged. This is not the case under the addition or subtraction method. As appears in more detail below, those methods contemplate the avoidance of a cascading tax-on-tax effect through taxing each stage of the commercial chain only on its *net value added*. Since that will not be determinable until the end of the fiscal period, it is impractical, except by the grossest system of approximation, to contemplate that such a tax will be passed on to each purchaser in the commercial chain. The addition and subtraction methods are compatible with an origin-principle tax, but not with a destination-principle tax. (Emphasis supplied).

C. The Michigan Single Business Tax Act

The Michigan SBT is a value added tax (i) of the consumption type utilizing (ii) the addition method of calculation and (iii) the origin principle.[6] While it is drafted without complete fidelity to the concept or structure of a pure VAT—departing from pure value added theory in part because of the inevitable political compromises that accompany the adoption of most tax laws—the Michigan Supreme Court has expressly characterized the SBT as a value added tax of the consumption type that uses the additive method to determine a taxpayer's preapportioned tax base. *Mobil Oil Corp. v. Dep't of Treasury*, 422 Mich. 473, 496, 373 N.W.2d 730, 741 (1985).

For a taxpayer that is engaged in business within and without Michigan, the SBT is calculated in essentially two steps. First, a preapportionment tax base is calculated; then the Michigan tax base, the value considered to have been added in Michigan, is determined by applying the three-factor apportionment formula commonly used to apportion state income taxes. After certain other post-

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[6] A symposium in Volume 22 of No. 4 of the Wayne Law Review contains several articles discussing various aspects of the Act. Particularly helpful are articles by James W. Haughey, then an assistant director of the Michigan Department of Management and Budget, reportedly one of the Act's draftsmen, and by Louis W. Kasischke. *See* Haughey, *The Economic Logic of the Single Business Tax*, 22 Wayne L. Rev. 1017 (1976); Kasischke, *Computation of the Michigan Single Business Tax: Theory and Mechanics*, 22 Wayne L. Rev. 1069 (1976). There is also an elaborate monograph discussing the SBT: R. Kleine, *The Michigan Single Business Tax: A Different Approach to State Business Taxation*, Advisory Commission on Intergovernmental Relations (March 1978). A publication of the Taxation and Economic Policy Office, Michigan Department of Treasury, *Analysis of the Michigan Single Business Tax* (Jan. 1985), contains an excellent description of the SBT and a wealth of financial information concerning its impact. The *Analysis*, however, largely ignores the application and effect of the tax on companies located primarily in states other than Michigan. The Appendix, *infra*, contains three pages from the *Analysis*. The complete document has been lodged with the Clerk of the Court.

apportionment adjustments, the tax liability is determined by multiplying the result by a flat tax rate of 2.35%. Because the postapportionment adjustments are not at issue, we focus here on how the preapportioned tax base is calculated and, then, how that preapportioned tax base is assigned to Michigan pursuant to the three-factor apportionment formula.

1. *The pre-apportioned tax base.* As is true of most state income tax statutes, the SBT constructs a tax base by beginning with a readily verifiable amount—federal taxable income—and then making adjustments by adding and subtracting certain amounts. Mich. Comp. Laws §§ 208.9(1), 208.3(3) (1979). There is a critical difference, however, in both the purpose and substance of the adjustments made by Michigan's tax and the corporate income taxes of other states. Virtually all state income tax statutes require adjustments to federal taxable income in order to establish the income appropriate for state tax purposes. Thus, interest on state and municipal bonds, excluded from federal taxable income, is often regarded as properly part of state taxable income. Similarly, state income taxes, deductible from federal taxable income, are added back in arriving at state taxable income. To take another example, interest on U.S. Treasury securities, included in federal taxable income, is subtracted in determining state taxable income because that income is not taxable by a state. 31 U.S.C. § 3124 (Supp. V 1987).

There is a wholly different purpose for the adjustments made to federal taxable income by the Michigan SBT—as the Michigan Supreme Court has explained. *Mobil Oil Corp. v. Dep't of Treasury*, 422 Mich. at 497, n.15, 373 N.W.2d at 741. The objective is not to establish state taxable income, but to establish the value added by the taxpayer's relevant business activities. Moreover, the significant adjustments are unlike any that appear in any state income tax statute. They are provided for in Mich. Comp. Laws Ann. §§ 208.9(4)(c), 208.9(4)(f)

and 208.9(5) (West 1989).[7] The most significant addition, made by Mich. Comp. Laws Ann. § 208.9(5), is the amount of all compensation paid by the taxpayer (including the fringe benefits specified in Mich. Comp. Laws Ann. § 208.4(3) (West 1989)). This addition alone constitutes almost 77% of the total tax base of all taxpayers.[8]

In addition, depreciation and amortization of capital assets, whether acquired prior to or after the adoption of the SBT, are added back by § 208.9(4)(c). All interest deducted in arriving at federal taxable income—representing the cost of capital supplied by others rather than by the taxpayer—is added back by § 208.9(4)(f).[9]

Since the profit earned by a taxpayer is the third component in a value-added tax base and because profit, for this purpose, is not very different from state taxable income, the SBT provides for several additions and subtractions that are the same as those customarily made in state corporate income tax statutes.[10] The total federal

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[7] The *Analysis of the Michigan Single Business Tax, supra* note 6, at 7, explains, simply, "The SBT value-added tax base is computed by adding up profits plus labor costs plus interest paid plus depreciation."

[8] *Analysis of the Michigan Single Business Tax, supra* note 6, at 27, Table 4 (1985). This Table is reproduced in the Appendix hereto, at 1a.

[9] Amounts paid for the rent of real and personal property, which also represent the cost of capital furnished by others, are not added back—one of the Act's departures from pure VAT theory. R. Kleine, *supra* note 6, at 7, states "[t]his departure from the normal value added treatment of rent was adopted to prevent a windfall gain for a few companies . . . and to avoid placing a penalty on many companies that prefer to lease rather than buy property and equipment."

[10] The SBT allows all interest received by the taxpayer to be deducted. Mich. Comp. Laws Ann. § 208.9(7)(b). The SBT deduction is allowed, for taxpayers other than financial organizations, because, like dividends received which are also deductible under the SBT,

taxable income comes to about 6% and the additions and subtractions, other than for depreciation and interest, although numerous and technical, are not quantitatively significant.[11]

In general, and as applied to all Michigan SBT taxpayers, the average components of the SBT tax base are: compensation, which comprises 76.7% of tax base; depreciation, interest and other additions, which comprise 23.3% of tax base; business income (federal taxable income), which comprises 5.7% of tax base; and miscellaneous subtractions, which comprise a negative 5.7% of tax base.[12]

Except for the profit element, then, which may be difficult to allocate directly to each of the states in which it was earned, *see Container Corp.*, 463 U.S. at 165-169, something approximating 90% or more of the tax base can be allocated, with complete precision, to each of the states in which the contributions to that tax base were made by the taxpayer.

2. *The apportionment to Michigan of its part of the tax base.* To determine what part of the tax base is assignable to Michigan, the Act applies a percentage derived from a three-factor formula which weights payroll, property, and sales equally. Mich. Comp. Laws § 208.45 (1979). The formula is essentially the same as the familiar three-factor formula embodied in the Uniform Division of Income for Tax Purposes Act, 7A U.L.A.

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it represents earnings upon investments and not value added to the products that are sold.

[11] There are special provisions, some quite complex but not material to the issues in this case, respecting the tax bases of financial institutions and insurance companies. See Mich. Comp. Laws Ann. §§ 208.21 and 208.22 (West 1989).

[12] *Analysis of the Michigan Single Business Tax, supra* note 6, at 27, Table 4 (1985), reproduced at App. 1a.

336 (1957), which the Court has considered on numerous occasions in recent years.[13]

The amount apportioned to Michigan is reduced by certain dollar amounts, Mich. Comp. Laws Ann. § 208.35 (West 1989), and by the capital acquisition deduction.[14] The tax rate is then applied to the result, called the "adjusted tax-base." Mich. Comp. Laws Ann. § 208.31(1) and (2) (West 1989).

The Act contains a number of additional provisions which reduce the tax for certain taxpayers.[15] Moreover, if the amount representing 50% of the taxpayer's nationwide gross receipts apportioned to Michigan by the three-factor formula (ignoring the fact that the tax-

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[13] *See, e.g., Container Corp. v. Franchise Tax Bd.; Exxon Corp. v. Department of Revenue*, 447 U.S. 207 (1980); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980). "The three-factor formula yields a percentage representing an average of three ratios: property within the State to total property, payroll within the State to total payroll, and sales within the State to total sales." *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 270 n.3 (1978).

[14] Instead of being allowed against the unapportioned tax base as value-added theory would seem to require, the cost of the capital asset is first apportioned by a two-part payroll and property factor formula. Mich. Comp. Laws Ann. § 208.23(a) (West 1989). The Michigan Court of Claims recently struck down the deduction as unconstitutional on the ground that it impermissibly discriminates against out-of-state businesses by favoring businesses with all or most of their operations in Michigan. *Caterpillar Inc. v. Michigan*, Nos. 84-9664-CM and 87-11109-CM (opinion and order entered July 13, 1989, final judgment entered Aug. 11, 1989), *appeal pending*, Mich. Ct. App. No. 119584.

[15] A reduction is provided for companies that are unusually labor-intensive. Mich. Comp. Laws Ann. § 208.31(4) (West 1989). A similar reduction for capital intensive companies in the original Act has been phased out and repealed. The same is true of reductions for food retailers, private security guard companies and businesses engaged in rental investments. There is a small business credit. Mich. Comp. Laws Ann. § 208.36(2) (West 1989). Neither these, nor several other credits, are relevant to the issues presented here.

payer's gross receipts in Michigan may be known precisely) exceeds the adjusted tax base, the base is reduced (unless another deduction is available) to that amount. § 208.31(2).

D. Application Of The Tax To Petitioner

Petitioner, a manufacturer of automobile components—primarily window glass during the year at issue—is incorporated under the laws of the state of Ohio and has its principal office in Maumee, Ohio. Nearly all of petitioner's operations are located outside of Michigan and are labor and capital intensive. Pet. App. 53a, Stipulation of Facts, ¶ 5. In 1980, petitioner's presence in Michigan consisted merely of an office with six clerical workers to support eight sales people who solicited orders for petitioner's glass division and provided liaison with petitioner's Michigan customers. *Id.* ¶ 4.

The chart below identifies each component of petitioner's 1980 SBT tax base together with how that tax base was apportioned to Michigan using the Act's three-factor formula.[16] The left hand column lists the components of the tax base. The middle column reflects the percentage of the total tax base each component comprises. The right hand column shows the amount of tax base apportioned to Michigan under the three-factor formula.

Computation of Petitioner's 1980 Apportioned Tax Base

	Tax Base	Percentage of Tax Base	Apportioned Tax Base (8.9717%)
	$	%	$
U.S. taxable income (loss)	(42,466,114)	(19)	(3,809,932)

[16] The accuracy of each individual line item referenced in this chart is not in dispute nor is the mathematical accuracy of the computations that are contained in the chart.

	Tax Base	Percentage of Tax Base	Apportioned Tax Base (8.9717%)
Add:			
Compensation	226,356,271	102	20,308,006
Depreciation	23,262,909	11	2,087,078
Dividends, interest and royalties paid	22,908,950	10	2,055,322
Other	549,526		49,302
Subtotal	230,611,542	104	20,689,776
Subtract:			
Dividends, interest and royalties received	(9,486,223)	(4)	(851,076)
Total	221,125,319	100	19,838,700
Apportionment			
Payroll Factor	.2328%		
Property Factor	.0930%		
Sales Factor	26.5892%		
Average Factor	8.9717%		
Apportioned Tax Base	19,838,700 (221,125,319 × 8.9717%)		

Petitioner's apportioned tax base of $19,838,700 was adjusted by subtracting the capital acquisition deduction and by the reduction allowed for high labor compensation costs, yielding an adjusted tax base of $12,492,671 and a 1980 tax, at 2.35%, of $293,578 before credits.[17]

E. The Proceedings Below

In 1985, a panel of the Michigan intermediate court of appeals ruled that taxpayers conducting business both

[17] The statutory adjustment for high labor costs, found in Mich. Comp. Laws Ann. § 208.31(4) (West 1989), permits an SBT taxpayer a deduction to the extent that its compensation divided by its tax base exceeds 63%.

within and without Michigan, who in all relevant respects were similarly situated to petitioner, were entitled to relief under § 208.69 of the Act. Mich. Comp. Laws § 208.69 (1979).[18] That so-called "relief" provision permitted a taxpayer, when the apportionment provisions of the Act did not fairly represent the extent of a taxpayer's business activity in Michigan, to petition for employment of another method of apportionment to effectuate an equitable allocation and/or apportionment of the taxpayer's tax base.

The taxpayers in *Jones & Laughlin* had tax bases comprised almost entirely of compensation; their actual compensation paid in Michigan could be determined accurately; and application of the statutory formula resulted in an apportionment of compensation to Michigan that was substantially higher than compensation directly allocable to the state.

The court therefore allowed the taxpayers to apportion their tax bases in an alternative fashion under § 208.69—namely, by initially excluding compensation from the tax base; applying the three-factor formula to the remaining tax base; and adding to that amount the actual amount of compensation paid to employees performing services in Michigan. The decision is reprinted at Pet. App. 63a-72a. It was the precursor of the instant case and the more than 400 others that are currently pending in Michigan courts involving the same questions that are presented here.

Relying on *Jones & Laughlin*, petitioner filed a refund claim with the Michigan Department of Treasury. It

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[18] *Jones & Laughlin Steel Corp. v. Department of Treasury*, 145 Mich. App. 405, 377 N.W.2d 397 (1985), *leave to appeal and reconsideration denied*, 424 Mich. 895 (1986). Section 69 was subsequently amended in 1987, Mich. Comp. Laws Ann. § 208.69 (West 1989).

was denied. Petitioner then filed the instant action in the Michigan Court of Claims. The Court of Claims disagreed with the Department of Treasury and ordered a refund. Pet. App. 8a-9a. The Michigan Court of Appeals reversed, Pet. App. 9a, and the Michigan Supreme Court affirmed.[19]

The Michigan Supreme Court began its analysis by rejecting the Court of Claims' view of § 208.69, which it characterized as converting the section "into an all-purpose tax equity provision." Pet. App. 15a. It held, rather, that § 208.69 functioned as a "constitutional 'circuit breaker,'" to be applied only if the Act, excluding that section, was unconstitutional. Pet. App. 16a. Since it found the Act otherwise constitutional, § 208.69 did not come into play.

The Court upheld the tax, despite its acknowledgement that the "single component" at issue—compensation—accounted for "a substantial portion of the tax base in most businesses," and the entire portion in petitioner's case. Pet. App. 22a. It refused to consider, however, whether compensation or depreciation can be clearly identified on a geographical basis—or, more precisely,

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[19] Petitioner's complaint in the Court of Claims at ¶ 13 alleged that the tax as applied to it violated the Due Process and Equal Protection Clauses because of the misattribution of petitioner's tax base. That court did not reach any constitutional issue, ruling in petitioner's favor on the basis of its construction of § 208.69 of the Mich. Comp. Laws. In the Michigan Court of Appeals petitioner argued that the SBT as applied to it violated the Due Process and Commerce Clauses, Brief on Appeal, filed December 21, 1987, at 20-26, although that court too based its ruling solely on the SBT. In the Michigan Supreme Court, petitioner argued that unless relief was available under § 208.69, petitioner would be subjected to unconstitutional taxation of extraterritorial business activity in violation of both the Due Process and Commerce Clauses. Brief on Appeal, filed July 8, 1988, pp. 10-27.

whether the value added by those elements of added value can be thus identified, leaving the profit element to be apportioned. Instead, it simply ruled that apportionment of the aggregate value-added tax base was constitutionally acceptable, relying principally on an income tax case, *Container Corp.*, 463 U.S. 159, 164 (1988). Pet. App. 22a.

In that connection, the Court ruled that the Act taxes "business activity," which includes "the complete range of entrepreneurial activities of which compensating employees is but one part." Pet. App. 22a. Consequently, it stated, that

> [T]o conclude that a taxpayer's business activity is not fairly apportioned because a single component of that activity, when examined by geographical accounting, is not accurately reflected under the statutory apportionment scheme belies the very definition of business activity.

Pet. App. 22a.

On this basis, the Michigan Supreme Court adopted the *Container Corp.* analysis without further discussion, asserting that "the failings of separate accounting" in income tax cases would necessarily require apportionment in value added cases as well as income tax cases. Pet. App. 23a, n.24. The Court thus accepted the income tax apportionment formula and concluded that the tax assessed against petitioner, when judged against its overall "business activity" conducted in the state, was constitutional because the grossly disproportionate attribution of value added to Michigan was offset by the fact that the dollar amount of product delivered in Michigan—an economic activity that added comparatively little value to the product—was substantial.

> Trinova's actual Michigan compensation was $511,774, and its actual property as reflected in its depreciation expense was $2,152. While these figures obviously represent a very small percentage of Trinova's total business activity, they are offset by its Michigan sales figure of $103,981,354. When viewed as a whole, we believe the averaged ratios of Trinova's payroll, property, and sales "actually reflect a reasonable sense of how [its Michigan business activity was] generated," clearly satisfying the constitutional requirements of internal and external consistency.

Pet. App. 24a-25a (bracketed material in original; footnote omitted).

SUMMARY OF ARGUMENT

I

Michigan's use of the familiar three-factor formula to apportion petitioner's value added tax base is unjustified on a theoretical basis and in practical effect produces an unconstitutional result. The three-factor formula was conceived as an answer to the difficult task of allocating a multistate taxpayer's *income* among the various states in which it does business, *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120-121 (1920), a task this Court has compared to "slicing a shadow," *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 192 (1983). The justification for apportionment vanishes, however, when the geographic locus of a tax base can be identified with precision. Michigan's SBT ignores this axiom. It wrongly assumes that the value added by the taxpayer's business activities cannot be specifically attributed to the states in which those activities are conducted. The assumption is wrong because the SBT itself identifies the taxpayer's value adding expenditures, and the value added by the two principal expenditures—compensation and depreciation—can and should be attributed precisely where they occur. Indeed, the State itself has conceded that if the SBT straightforwardly taxed compensation, state-by-state allocation, not apportionment, would be required. (See Pet. 12).

Michigan's SBT recognizes that a business adds value to its product through the work performed by its employees (measured by compensation), the "work" of its capital (measured by depreciation and interest paid), and management's entrepreneurial efforts (measured by profit). But compensation and depreciation, we are told by the Michigan Treasury Department, account for 90% or more of the total SBT tax base.[20] These elements of added value bear no relation to the "factors of profitability" that contribute to a multistate corporation's income, such as "functional integration, centralization of management, and economies of scale." *Mobil Oil Corporation v. Comm'r of Taxes*, 445 U.S. 425, 438 (1980). Those abstract factors baffle the effort "to characterize the income of the business as having a single identifiable 'source'." *Id.* By contrast, the source of the compensation and depreciation elements of added value lies precisely at the place where the value adding activities occur.

The consequence of Michigan's having chosen wrongly to use the three-factor apportionment formula is that the SBT cannot meet the Due Process and Commerce Clause mandate that apportionment be fair. *Container Corp.*, 463 U.S. at 169. The fair apportionment requirement means that the apportionment factors must "actually reflect a reasonable sense of how . . . [value] is generated," *id.*; that the formula not "project the taxing power of the state plainly beyond its borders" by taxing extraterritorial value, *Nashville, Chattanooga & St. L. Ry. v. Browning*, 310 U.S. 362, 365 (1940); and that the tax not lead to a "grossly distorted result." *Norfolk & Western R.R. v. State Tax Comm'n*, 390 U.S. 317, 326. Michigan's SBT fails on all counts.

The three-factor formula of property, payroll, and sales does not reflect a reasonable sense of how the SBT

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[20] *Analysis of the Michigan Single Business Tax, supra* note 6.

tax base is generated, principally because of the inclusion of the sales factor. In the typical case, as we have seen, at least 90% of the SBT tax base consists of compensation and depreciation (and in petitioner's case they constitute 113%). Sales have no relationship to the value that these two factors contribute to the tax base, and indeed have almost no role in petitioner's value adding activities. Hence they do not reflect a reasonable sense of how value was added in Michigan.

What the inclusion of the sales factor in the formula does do is this: it assigns a substantial portion of petitioner's tax base to Michigan even though almost all of the base is comprised of value adding activities—compensation and depreciation—that occurred and added value in Ohio. Thus the formula's use means that the SBT taxes value added outside Michigan's borders, in violation of the fundamental principle that states may not tax extraterritorial value.

The inclusion of the sales factor also yields a grossly distorted result. Petitioner's payroll factor (Michigan payroll over total payroll) was .2328%, its property factor .0930%. The two average .1629% and yield an apportioned tax base of $360,213. When the sales factor of 26.5892% is added the average jumps 55 times to 8.9717% and the apportioned tax base to $19,838,700. The distortion is caused because sales by themselves add almost no value. The added value associated with sales comes in one of two ways—through compensation paid to sales personnel, and through profit, assuming sales include a markup. But the compensation will already be in the tax base and will be apportioned through the payroll factor; and the value added by profit comprises only a minor element of total added value and does not merit equal treatment with the major items of payroll and property. The resulting distortion in petitioner's case can be measured not only by the jump in the apportioned tax base but also by the degree of misallocation of its principal components. Almost all of petitioner's preap-

portioned tax base consisted of site specific components—compensation and depreciation; and the parties have stipulated that petitioner's actual Michigan compensation and depreciation were $511,744 and $2,152. Pet. App. 54a-55a, Stipulation of Facts, ¶¶ 8-10. Yet the three-factor formula apportioned to Michigan $20,308,006 in compensation and $2,087,078 in depreciation. Thus, apportionment overstated actuality by 3,900% and 97,000%, respectively, and has produced a tax "out of all appropriate proportion to" petitioner's business in Michigan. *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 135 (1931).

In sum, Michigan has chosen, as it is free to have done, to adopt an additive type VAT operating on the origin principle. It is not free, however, to use the familiar three-factor formula to apportion the SBT tax base. That formula, devised to apportion state income taxes, is fundamentally inconsistent with the nature of a VAT and makes it impossible for the SBT to satisfy the requirements of the Due Process Clause and the Commerce Clause that a tax be fairly apportioned.

II

The SBT also discriminates against out-of-state businesses, in violation of the Commerce Clause. It does so by systematically reducing the tax base of businesses located principally within the state that sell their products elsewhere while systematically increasing the tax base of businesses located principally outside the state that sell their products in Michigan. Here again the villain is the sales factor, and the unconstitutional result stems from its application to a tax base composed almost entirely of compensation and depreciation. Use of a sales factor in the apportionment formula causes compensation and depreciation of those taxpayers whose labor force and physical plant are located within the state to be wrongly exported out of the state and, therefore, out of their SBT tax bases. At the same time, the formula wrongly

imports into Michigan compensation and depreciation of those taxpayers whose labor force and physical plant are located in states other than Michigan. By impermissibly favoring local enterprises while pressuring out-of-state companies to shift their operations to Michigan, the tax violates the central teachings of the Court's Commerce Clause doctrine. *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388 (1984); *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329 (1977); *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64 (1963).

ARGUMENT

I. MICHIGAN'S USE OF AN INCOME APPORTIONMENT FORMULA TO ATTRIBUTE PETITIONER'S VALUE ADDED TAX BASE TO THE STATE IS UNJUSTIFIABLE IN THEORY AND IN PRACTICE VIOLATES THE FAIR APPORTIONMENT REQUIREMENT OF THE DUE PROCESS AND COMMERCE CLAUSES

A. There Is No Justification For The Use Of An Apportionment Formula To Assign A Value Added Tax Base Because The Principal Components Of The Value Added Tax Base Are Identifiable And May Be Precisely Allocated On A Geographical Basis

The use of a formula to divide a tax base among taxing jurisdictions is justified by the conceptual and practical difficulties that are sometimes encountered in directly delineating a tax base on a geographic basis. The Court has squarely recognized this fact in the context of state income taxation where these difficulties are especially acute. Indeed, the difficulty of accurately identifying a multistate enterprise's income tax base on a geographic basis established the essential predicate for the Court's sanction of apportioned net income taxes in its very first opinion addressed to the constitutionality of such taxes.

In *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920), the taxpayer complained that the formula employed to apportion its profits to the taxing state did not fairly reflect the portion of its profits actually received in that state. In rejecting this claim, the Court observed that "[t]he profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut, and ending with sale in other states," and the legislature "was faced with the impossibility of allocating specifically the profits earned by the processes within its borders." *Underwood*, 254 U.S. at 120-121. Because the legislature had "adopted a method of apportionment which . . . reached, and was meant to reach, only the profits earned within the state" and because there was "nothing . . . to show that the method of apportionment adopted by the state was inherently arbitrary, or that its application to this corporation produced an unreasonable result," *id.* at 121 (footnote omitted), the Court sustained the apportioned levy. *See also, Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924).

The Court's contemporary opinions involving questions of apportionment continue to recognize that the underlying justification for using an apportionment formula is the difficulty, if not impossibility, of pinpointing the tax base of a multistate business on a geographic basis. Thus, in *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 438 (1981), the Court found an apportioned net income tax justified because the 'factors of profitability arise from the operation of the business as a whole," and "it becomes misleading to characterize the income of the business as having a single identifiable 'source.'" Perhaps Justice Powell summed it up best when he observed that apportionment "owes its existence to the fact that with respect to a business earning income through a series of transactions beginning with manufacturing in one State and ending with a sale in another, a precise—or even wholly logical—determination of the State in which any

specific portion of the income was earned is impossible." *Moorman Mfg.*, 437 U.S. at 286 (Powell, J., dissenting).

Because the underlying justification for apportionment is the difficulty of determining the tax base of an interstate enterprise on a geographic basis, when the geographic locus of a tax base *can* be identified with precision the justification for apportionment evaporates. Thus, there is no warrant for apportioning an ad valorem tax on the real or immobile personal property of an interstate mercantile or manufacturing enterprise, like petitioner, and no taxing jurisdiction in the country attempts to do so. Because the geographic situs of a taxpayer's plant and immobile equipment, and its attendant value, can be identified with geographic precision, any attempt to determine the tax base by reference to an apportionment formula (containing factors other than the property itself) would necessarily lead to geographic misattribution of the tax base. An apportionment formula cannot be used as a means of permitting a state to appropriate into its tax base that which, under the state's chosen method of taxation, in fact and theory belongs to the taxing jurisdiction of another state.

There is likewise no justification for apportionment of the principal elements of Michigan's SBT base. As we have seen, the SBT is based on the origin principle of taxing value where it is added; but the apportionment used by Michigan is fundamentally inconsistent with the basic notion of such a value added tax. The primary components of value added, compensation and depreciation, are readily capable of precise territorial allocation both in theory and practice. The State itself has effectively conceded these points. It has acknowledged that, if Michigan forthrightly imposed a tax directly on compensation, it "would apply to a tax subject so inherently locale-specific as to require specific allocation" to the state in which the compensation was paid. *See* Pet. 12. And the State's stipulation as to the actual value of Trinova's Michigan compensation and depreciation (Pet.

App. 54a-55a) disposes of any suggestion that precise geographic identification of Trinova's SBT base is beset with practical difficulties.

The inappropriateness of employing an apportionment formula for determining a taxpayer's Michigan SBT base was clearly recognized by two independent economists:

> The standard three-factor formula used for determining what fraction of a multistate firm's value added should be taxable under the SBT is a cumbersome method of arriving at the wrong answer. Since value added consists of payments to labor and to capital, whose location in both cases is relatively unambiguous, there is no reason why value added in Michigan should not be measured directly.

R. Barlow and J. Connell, Jr., *The Michigan Single Business Tax in Michigan's Fiscal and Economic Structure* 673, 704 (U. Mich. Press, Braxer, H., ed. 1982).

The fundamental flaw, then, with the SBT's adoption of a formula to apportion the tax base is its false assumption that the value added by the taxpayer's business activities cannot be specifically attributed to the states in which it conducts those activities. The assumption is wrong because the Act itself identifies the expenditures of the taxpayer that add value to the inputs it receives, and the value that the two principal expenditures add can and should be attributed precisely where they are actually incurred. In this respect, the components of added value are conspicuously unlike the abstruse and elusive elements of profit that justify apportionment of net income.

A business adds value to its ultimate product principally through the efforts of its employees (reflected in their compensation), the dedication of its capital (reflected in depreciation and interest paid), and the entrepreneurial talents of its management (reflected, one may hope, in profit). The Act in § 208.9 explicitly recognizes these "inputs" to added value by constructing a tax base reflecting compensation plus depreciation plus adjusted "business income" (i.e., profit).

With the exception of profit, which is an appropriate subject for apportionment for the same reasons it is apportioned in income tax cases, these inputs of added value are demonstrably different from the "factors of profitability" that contribute to a multistate corporation's income—such as "functional integration, centralization of management, and economies of scale." *Mobil Oil Corp.*, 445 U.S. 425, 438 (1980). Those abstract and conceptual factors confound the effort "to characterize the income of the business as having a single identifiable 'source.'" *Id.* The source of the compensation and depreciation components of added value, by contrast, lies at the place where the value adding activities—production, transportation, marketing, etc.—occur, and that location can be determined precisely.

In mechanically applying this Court's income tax apportionment decisions to rationalize Michigan's apportionment of the SBT base, the Michigan Supreme Court wholly lost sight of the underlying justification for apportionment on which this Court's income tax decisions rest. For example, the Michigan court relied heavily on *Container Corp.*'s admonition that "arriving at precise territorial allocations of 'value' is often an elusive goal, both in theory and in practice" (Pet. App. at 18a (quoting *Container Corp.*, 463 U.S. at 164)). While this observation goes far to justify apportionment of net income, whose precise territorial allocation may fairly be described as "elusive," it simply is not germane to the SBT base, whose precise territorial allocation is clearly identifiable both in theory and practice. By the same token, the Michigan court's invocation of *Container Corp.*'s remark that separate geographical accounting "often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the

components of a single enterprise," (Pet. App. at 22a, quoting *Container Corp.*, 463 U.S. at 164-165), has no bearing in the context of taxing value where it is added, largely through the distinctly unsubtle and plainly quantifiable components of compensation and depreciation.

The Michigan court also sought to defend its decision by suggesting that what Michigan really taxes is not value added, but instead an amorphous and indivisible concept called "business activity," which is no more geographically identifiable than the net income that most states tax under their corporate income taxes, and hence equally subject to apportionment. *See* pp. 17-19, *supra*. But this facile analysis cannot withstand constitutional scrutiny. As this Court has made clear, the touchstone of constitutional review of a state tax is "the practical effect of a challenged tax," *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. at 443, and "economic realities." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). Accordingly, "[t]here is no economic consequence that follows necessarily from the use of the particular words, 'privilege of doing business,' and a focus on that formalism merely obscures the question whether the tax produces a forbidden effect." *Complete Auto*, 430 U.S. at 288. It is the same with the phrase "business activity": its use cannot obscure the question of forbidden effect. As shown above, the distinguishing feature of a value added tax such as Michigan's is that it is possible to identify precisely the components of the tax base, and to locate precisely the principal ones—compensation and depreciation. The Michigan Supreme Court cannot escape that conclusion by an *ipse dixit* which is simply inconsistent with the practical and intended effect of the tax.

B. The Application Of Michigan's Three-Factor Formula To Attribute Petitioner's Value Added Tax Base To The State (1) Does Not Reasonably Reflect The Value Petitioner Adds In Michigan, (2) Imposes A Tax On Value Petitioner Adds Outside Of Michigan, And (3) Produces A Grossly Distorted Result

There is no reason why formulary apportionment should be employed by a VAT to assign fairly to the taxing jurisdiction the principal portions of a taxpayer's total tax base. Having sought nonetheless to apportion such a tax base, Michigan must comply with the well settled constitutional principle that a tax be fairly apportioned. While the Court has articulated this principle in a variety of ways and in a variety of contexts, the essence of the fair apportionment requirement, which applies no less to value added than to income or property taxes,[21] is that "an apportionment formula must, under both the Due Process and Commerce Clauses, be fair." *Container Corp.*, 463 U.S. at 169. This means, among other things, that "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated," *id.*; that the formula not "project the taxing power of the state plainly beyond its borders" by taxing extraterritorial value, *Nashville, Chattanooga & St. Louis Ry. v. Browning*, 310 U.S. 362, 365; and that the tax not lead to "a grossly distorted result." *Norfolk & Western R. Co. v. State Tax Comm'n*, 390 U.S. 317, 326. The application of Michigan's three-factor apportionment formula to petitioner's SBT tax base fails each one of these tests.

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[21] "[I]f an apportionment method results in the taxation of a larger portion of the income, capital stock, property, *or other tax base* than is properly attributable to the state, under established legal doctrine, the taxpayers' rights, protected by the Due Process Clause, have been infringed." J. Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of the Unitary Business*, 21 Nat'l Tax J. 487 (1968) (emphasis added, footnote omitted).

1. *The Three-Factor Formula Does Not Reflect A Reasonable Sense Of How The SBT Tax Base Is Generated*

The three-factor formula of property, payroll, and sales was developed in the context of state income taxation to reflect the contributions made by the states to the production of that income. *See State Taxation of Interstate Commerce: Report of the Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary*, H.R. Rep. No. 1480, 88th Cong., 2d Sess. 99-136 (1964). This Court recognized the essential justification for the three-factor formula for apportioning net income because the three factors reflect "the relative contribution of the activities in the various states to the production of the total unitary income . . . ." *Butler Bros. v. McColgan*, 315 U.S. 501, 509 (1942) (citation omitted). The Court subsequently remarked that "[t]he standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates." *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 561 (1965). Indeed, the Court has now come to acknowledge that the three-factor formula is something of a "benchmark" against which other income tax apportionment formulas are judged. *Container Corp.*, 463 U.S. at 170.

The fact that the three factors in the standard income apportionment formula may reasonably reflect how income is generated, however, does not, except by sheer happenstance, mean that those factors will reflect how some other tax base is generated. It is therefore not surprising that the SBT's income tax apportionment formula fails reasonably to reflect how the SBT tax base is generated.

That is because there is no plausible justification for including a sales factor in the SBT apportionment formula. A taxpayer's sales are singularly inappropriate as a means for assigning to Michigan a tax base that

consists primarily of compensation and depreciable plant. Sales have no relationship to, and add nothing to, the value that these principal factors contribute to the tax base in Michigan. Indeed, in petitioner's case compensation and depreciation constitute 113% of the value added tax base.[22] Even allowing for a generous margin of error, sales do not "reflect a reasonable sense" of how petitioner's SBT tax base was generated in Michigan. As two outside observers have noted, the three-factor formula measures value added "incorrectly . . . by giving weight to sales, which do not measure the employment of a factor of production, and hence are not a component of value added." R. Barlow and J. Connell, Jr., *supra*, p. 26, at 704.

2. *The Application Of The Three-Factor Formula Imposes A Tax On Value Petitioner Adds Outside Of Michigan*

Perhaps the most fundamental aspect of the fair apportionment requirement is that a state may not "tax value earned outside its borders." *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982). As a result of the application of the three-factor formula to petitioner's tax base, the SBT fails to pass constitutional muster on this ground too.

As the Michigan Supreme Court has observed, the SBT taxes "the use of the resources of society. . . ." *Mobil Oil Corp. v. Department of Treasury*, 422 Mich. at 494, 373 N.W.2d at 740. Those resources, petitioner's labor and petitioner's plant, were used where they were consumed—in this case almost entirely in Ohio. Their use added value to goods ultimately delivered in Michigan, but the delivery itself did not. The value had been added before and in Ohio, when and where the labor

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[22] See Table, *supra*, pp. 14-15. Compensation ($226,356,271) and depreciation ($23,262,909) sum to $249,619,180 which, when divided by petitioner's total tax base of $221,125,319, yields 113%.

and plant were consumed. Under the origin principle of taxation, the tax on value added is levied at the source of production, *i.e.* at the origin. R. Kleine, *supra* note 6, at 7 and 14, n.5. Hence it is Ohio, not Michigan, that is entitled to tax the value added in Ohio.[23] Nevertheless, by thoughtlessly incorporating the three-factor formula into the SBT, Michigan has assigned to itself a substantial portion of the value added in Ohio. The sales factor, despite its irrelevance to an origin principle VAT, effectively assigns a disproportionate amount of tax base to the state in which petitioner makes its sales. Because petitioner makes substantial sales into Michigan, a substantial portion of petitioner's value added—which is comprised mostly of petitioner's Ohio compensation and plant—is assigned to Michigan. The application of the three-factor formula therefore violates the cardinal principle that states may not tax extraterritorial value.

3. *The Application Of The Three-Factor Formula To Petitioner's SBT Base Leads To A Grossly Distorted Result*

In large part because the three-factor formula fails reasonably to reflect petitioner's SBT base and because it sweeps extraterritorial values into that base, it imposes a tax "out of all appropriate proportion to" petitioner's business in Michigan, *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135

[23] We understand that Brazil is the only country where origin based VATs are actually used at the state level. There, each state imposes a VAT, on an origin basis, on the value added by firms within that state. M. Guerard, *The Brazilian State Value Added Tax*, International Monetary Fund Staff Papers, Vol. XX, No. 1, March 1973, pp. 118, 125-128. In 1950, Japan adopted an origin principle VAT that was to be applied at the prefecture level, but was never implemented. The tax base would have been allocated among prefectures according to payrolls except in the case of manufacturing activities for which it was to be allocated 50% on the basis of payroll and 50% on the basis of fixed assets. C. Sullivan, *supra* note 2, at 140.

(1931), and leads to "a grossly distorted result." *Norfolk & Western Ry.*, 390 U.S. at 326. Once again, these consequences may be traced to respondent's unthinking inclusion of a sales factor in the SBT apportionment formula.

The sales factor in the formula as applied to petitioner in fact measures deliveries in the state.[24] There is no value added by the delivery *per se*. Any value added that is associated with delivery is to be found in the wages of the deliverers (if they are petitioner's employees), which is already accounted for in the payroll factor.[25] Yet, for a business like petitioner's with large deliveries in Michigan but small amounts of actual compensation and depreciation (the major components of value added) inclusion of the sales factor produces a grotesque misapportionment. Petitioner's payroll factor (Michigan payroll over total payroll) was .2328%. Its property factor was .0930%. Those two factors, reflecting the major portions of added value, average .1629%, a percentage which, when applied to petitioner's tax base of $221,125,319, would yield an apportioned tax base of $360,213. When the sales factor of 26.5892% is added, however, the average jumps over 55 times to 8.9717%, and the apportioned tax base to $19,838,700, as the chart set forth below reveals:

[24] For purposes of apportionment, sales are considered to have occurred in Michigan if the destination, or point of delivery, is in Michigan, regardless of the free-on-board point or other conditions of sale. Mich. Comp. Laws § 208.52(a) (1979). Petitioner's shipment of goods to Michigan customers is F.O.B. Ohio. Thus, under the Uniform Commercial Code, the transfer of title takes place in Ohio. Mich. Comp. Laws § 440.2401(2)(a) (1979).

[25] If the deliveries are made by an independent transportation company, the employees' wages will be reflected in the compensation component of the value added tax base of that company.

Description of Line Item	Apportioned Tax Base (Using Statutory Three Factor Formula)	Apportioned Tax Base (Using Property and Payroll Factors Only)
1. Tax Base	$221,125,319	$221,125,319
2. Payroll Factor	.2328%	.2328%
3. Property Factor	.0930%	.0930%
4. Sales Factor	26.5892%	—
5. Average Factor	8.9717%	.1629%
6. Apportioned Tax Base (line 1 × line 5)	$ 19,838,700	$ 360,213

This distortion is attributable to the fact—which by now should be apparent—that sales, in and of themselves, have no proper independent function in the determination of a value added tax. Sales activities can add value in only two ways— through the compensation paid to employees engaged in sales efforts, and through profit to the extent that the sales include a markup. But the value added by compensation paid to salespersons will already be in the tax base and apportioned through the payroll factor and should not be duplicated by the sales factor. The remaining value added—profit—generally accounts for a minor percentage of total added value, and does not deserve equal footing with the major items of payroll and property. Indeed, in petitioner's case, since it suffered a loss, there was no value whatsoever added in the form of profit. Yet inclusion of the sales factor in the formula meant the difference between an apportioned tax base of $19,838,700 and $360,213.

Petitioner has clearly demonstrated the requisite "distortion" for constitutional relief. It is undisputed that compensation comprised 102% of petitioner's tax base, and that petitioner's compensation apportioned to Michigan was $20,308,006. Yet petitioner and respondent have stipulated that actual Michigan compensation—that is, compensation paid to those of petitioner's employees who performed services in Michigan—was only $511,774. Pet. App. 54a, Stipulation of Facts, ¶ 8 and ¶ 9. Thus, petitioner's apportioned Michigan compensation [26] overstated its actual Michigan compensation by 39 times, or 3,900% ($20,308,006 versus $511,774). Likewise, depreciation, which comprised 11% of petitioner's tax base, was apportioned to Michigan in the amount of $2,087,078.[27] Petitioner and respondent have stipulated that depreciation attributable to Michigan—depreciation associated with those of petitioner's depreciable assets that were physically located in Michigan—was only $2,152. Pet. App. 54a-55a, Stipulation of Facts, ¶ 8 and ¶ 10. Thus, petitioner's apportioned Michigan depreciation exceeded its actual Michigan depreciation by 970 times, or 97,000% ($2,087,078 versus $2,152).

The misguided assumption underlying the Act's apportionment provisions—that compensation and depreciation cannot be precisely identified on a geographic basis—has produced a constitutionally intolerable result in this case. In *Hans Rees' Sons*, the state's apportionment formula attributed 85% of the taxpayer's income to North Carolina, as compared to a separate accounting analysis which attributed at most 21.7%. It was "the more than 250% difference which led [the Court] to strike down the [North Carolina] tax. . . ." *Container Corp.*, 463 U.S. at 184. Yet, based on *stipulated* facts, the Act has produced distortions of 3,900% and 97,000%. These figures are far beyond "the substantial margin of error inherent in any method" of apportioning the tax base of a multistate company, *id.*, and condemn the tax.

The unconstitutionality of the SBT is not cured by the fact that Michigan could have imposed a tax upon petitioner as great as or greater than the tax imposed by the

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[26] $20,308,006, determined by multiplying total compensation of $226,356,271 times the 8.9717% average factor.

[27] Determined by multiplying total depreciation of $23,262,909 by 8.9717%

Act. Petitioner concedes that it is subject to taxation by Michigan and that Michigan could constitutionally have adopted a gross receipts tax measured by the value of the products delivered to Michigan customers. In *Moorman*, 437 U.S. at 280, the Court responded to a contention that Iowa's income tax was unconstitutional because the use by other states of apportionment formulas different from Iowa's resulted in multiple taxation. The Court held that the fact that multiple taxation might or did result did not constitute a burden on interstate commerce. A tax act has to be examined on its own, without regard to what other states might do or actually did. *Armco, Inc. v. Hardesty*, 467 U.S. 638, 644-645 (1984). In passing, the Court noted that a more burdensome form of multiple taxation could constitutionally have been imposed by Iowa in the form of a gross receipts tax.

But that *dictum* obviously did not mean that an unconstitutional tax can be supported by the state's power to raise the same amount of money by a different, constitutional tax. Indeed, the Court has held squarely to the contrary. In *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327 (1944), the Court struck down Arkansas' attempt to levy a sales tax on products sold elsewhere and delivered into Arkansas. The state defended the tax by contending that it could validly have imposed a use tax. This Court quickly disposed of that contention:

> It is suggested, however, that Arkansas could have levied a tax of the same amount on the use of these goods in Arkansas by the Arkansas buyers, and that such a use tax would not exceed the limits upon state power derived from the United States Constitution. Whatever might be the fate of such a tax were it before us, the not too short answer is that Arkansas has chosen not to impose such a use tax, as its Supreme Court so emphatically found. A sales tax and a use tax in many instances may bring about the same result. But they are different in conception, are assessments upon different transactions, and in

> the interlacings of the two legislative authorities within our federation may have to justify themselves on different constitutional grounds.

McLeod, 322 U.S. at 330. Michigan chose not to adopt—as most states have chosen not to adopt—a gross receipts tax. The fact that it might have taxed petitioner on its sales in Michigan but didn't is not relevant to the constitutional issues presented here.

Nor is it relevant that for some taxpayers (but not for petitioner) the tax base is reduced to 50% of the portion of their gross receipts that the Act arbitrarily attributes to Michigan. *See* pp. 13-14, *supra*. That does not convert the SBT into a gross receipts tax. For the large majority of taxpayers this limit is inapplicable.[28] They are taxed on the value they add to their products and services without reference to their gross receipts. As noted above, the SBT incorporates a number of departures from a "pure" VAT that serve to reduce the amount that such a tax would have imposed. *See* note 15, *supra*. The fact that one of these departures employs gross receipts as the mechanism does not make the SBT something other than a VAT and it cannot serve to convert an unconstitutional tax into one that is constitutional.

In sum, Michigan's use of a three-factor formula, designed for state income taxes, to apportion petitioner's SBT tax base has transgressed the requirements of the Due Process and Commerce Clause that a tax be fairly apportioned. That is because the formula is fundamentally inconsistent with the underlying nature of the value added tax it has chosen to adopt. Whether the constitutional infirmity be characterized as a mismatching of the tax base and the apportionment factors, the taxation of extraterritorial value, or the creation of a grossly distorted result, the conclusion is the same.

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[28] *Analysis of the Michigan Single Business Tax*, *supra* note 6, at 34, Table 8, reproduced at App. 3a.

II. THE SBT DISCRIMINATES AGAINST OUT-OF-STATE BUSINESSES, IN VIOLATION OF THE COMMERCE CLAUSE

"[T]he Commerce Clause prohibits a State from imposing a heavier tax burden on out-of-state businesses that compete in an interstate market than it imposes on its own residents who also engage in commerce among States." *American Trucking Ass'ns, Inc. v. Scheiner*, 483 U.S. 266, 282 (1987) (footnote omitted); *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 335 (1977). The Act's compliance with this prohibition must be analyzed in light of its overall operation and purposes, for, "[i]n its guarantee of a free trade area among States . . . the Commerce Clause has a deeper meaning that may be implicated even though state provisions . . . do not allocate tax burdens between insiders and outsiders in a manner that is facially discriminatory." *American Trucking*, 483 U.S. at 281 (footnote omitted).

Before Michigan adopted the Act it had a corporate income tax which, of course, did not tax compensation but instead treated it as a deduction in arriving at the income tax base. In replacing the corporate income tax with the Act, the legislature "intended to reduce the heavy burden of taxation on capital in Michigan."[29] The decreased burden on capital intensive industries was expected to encourage more capital investment in Michigan and stimulate the state's economic growth—i.e., "to promote the development and investment of business within Michigan." Executive Message of Michigan Governor James J. Blanchard to the Michigan Supreme Court, Pet. App. 73a (inner quotation and footnote omitted). But it also results in an "increase [in taxes] for firms in

[29] Haughey, *supra* p. 3, at 1021-1022. The intended and practical effect of the Act is discussed in detail in Haughey, *supra* p. 3, at 1021-1024. *See also*, R. Kleine, *supra* note 6, at 39-43.

labor intensive industries."[30] More important, it does so in a manner that systematically reduces the tax bases of businesses located principally within the state that sell their products elsewhere while systematically increasing the tax bases of businesses located principally outside the state that sell their products in Michigan.

The Act's systematic discrimination in favor of local and at the expense of out-of-state businesses is the inexorable consequence of the application of the familiar three-factor apportionment formula, with a sales factor, to a tax base comprised almost entirely of compensation and depreciation and interest. The point can be made with the following example. Assume two businesses, a "Michigan business" and an "Ohio business," each a mirror image of the other, with a total SBT tax base of $1,500,000, comprised, as Michigan's statistics tell us, of 77% compensation, approximately 6% profit, and, after giving effect to miscellaneous other additions and subtractions, 17% for such items as depreciation and interest. *See* p. 12, *supra*. Assume further that both businesses have property, payroll and sales in only two states, Michigan and Ohio. If the Michigan business has 98% of its property and payroll in Michigan, and 60% of its sales in Michigan, application of the three-part formula will apportion 14.67% of its compensation to Ohio.[31] If the Ohio business has 2% of its payroll and property in Michigan and 40% of its sales in Michigan, the three-part formula will attribute 14.67% of its compensation to Michigan.[32]

Thus the Ohio business, with virtually none (approximately $23,100) of its compensation in Michigan, will be

[30] *Haughey, supra* p. 3, at 1022.

[31] The arithmetic is: 98% payroll in Michigan plus 98% property in Michigan plus 60% sales in Michigan = 256%, which divided by 3 = 85.33% attributed to Michigan, and the remaining 14.67% attributed out of state.

[32] Thus: 2% payroll plus 2% property plus 40% sales = 44%, which divided by 3 = 14.67% attributed to Michigan.

taxed on $169,439 of the value added by the labor of its employees. The Michigan business, with virtually all of its compensation (approximately $1,131,900) in Michigan, will have $169,439 of the value added by its labor attributed to Ohio and *not* taxed in Michigan.[33] Thus for the Ohio business the formula attributes $146,339 *more* compensation to Michigan than it actually pays to its Michigan based employees; while, for the Michigan business, the formula attributes $146,339 *less* compensation to its Michigan employees than it actually pays those employees.[34] The foregoing example is illustrated by the following chart:

Description of Line Item	Michigan Business		Ohio Business	
Component of Tax Base	Dollar Amount	%	Dollar Amount	%
1. Compensation	$1,155,000	77%	$1,155,000	77%
2. Depreciation/ Interest	255,000	17%	255,000	17%
3. Profit	90,000	6%	90,000	6%
4. Total Tax Base (sum of lines 1, 2, 3)	$1,500,000	100%	$1,500,000	100%
	(Michigan)	(Ohio)	(Michigan)	(Ohio)
5. Payroll factor	98%	2%	2%	98%
6. Property factor	98%	2%	2%	98%
7. Sales factor	60%	40%	40%	60%
8. Average factor	85.33%	(256% + 3)	14.67%	(44% + 3)

[33] Calculated as follows: the compensation component (77%) of the $1,500,000 tax base is $1,155,000 of which 14.67% is $169,439. For the Ohio company, however, with only 2% of its payroll in Michigan, actual Michigan compensation would be approximately $23,100 (2% of $1,155,000). For the Michigan company, with 98% of its payroll in Michigan, actual Michigan compensation would be approximately $1,131,900 (98% of $1,155,000).

[34] For the Ohio business, the difference between actual compensation of $23,100 and attributed compensation of $169,349 is $146,339. For the Michigan business the figures are $1,131,900 of actual compensation and $985,561 of attributed compensation ($1,155,000 less $169,439), also yielding a difference of $146,339.

9. Actual Michigan Compensation (line 1 × line 5)	$1,131,900		$ 23,100
10. Apportioned Michigan Compensation (line 1 × line 8)	985,561		169,439
11. Over (under) Apportionment to Michigan (difference between lines 9 and 10)	(146,339)		146,339

If we extended the example by calculating the formula's effect on the depreciation component of the tax base, we would find similar results. For both taxpayers the three-part formula not only attributes amounts to the wrong place, but also does so in a way that reduces the tax base for Michigan-based companies while increasing it for out-of-state companies.

That a discriminatory result arises from application of the SBT's apportionment formula is hardly surprising. Robert Kleine, a principal draftsman of the SBT, has stated that "[a] major advantage of the VAT is that the potential exists for 'exporting' the tax to taxpayers outside the state. (A tax is exported to the extent that it is shifted forward or backward to residents outside the taxing jurisdiction.)" R. Kleine, *supra* note 6, at 23.

This result brings the Act squarely within the reach of this Court's decisions striking down other discriminatory state taxes. *American Trucking* held that Pennsylvania's flat taxes "discriminate against out-of-state vehicles by subjecting them to a much higher charge per mile traveled in the State" than the comparable charge on local vehicles. *American Trucking*, 483 U.S. at 290. The Court ruled that, since the taxes "impose a cost per mile on appellants' trucks that is approximately five times as heavy as the cost per mile borne by local trucks, the taxes are plainly discriminatory." *Id.* at 286 (footnote omitted). Michigan's SBT likewise discriminates against out-of-state businesses by imposing on them a far greater tax

burden per dollar of actual value added in Michigan than the tax imposes on taxpayers with their labor force and physical plant located principally within the state.

Similarly, in *Maryland v. Louisiana*, 451 U.S. 725, 757 (1981), the Court invalidated a Louisiana tax scheme on the ground that its "obvious economic effect . . . is to encourage natural gas owners involved in the production of [Outer Continental Shelf] gas to invest in mineral exploration and development within Louisiana rather than to invest in further OCS development or in production in other States." And in *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984), this Court struck down a New York statute which provided a greater tax credit for export activity originating in, rather than out of, the state. The Court ruled that "[w]hether the . . . [New York credit] diverts new business into the State or merely prevents current business from being diverted elsewhere, it is still a discriminatory tax . . . ." *Westinghouse*, 466 U.S. at 406.

While the above referenced cases involved tax credits and tax exemptions which favored local business, the discriminatory effect of the Act's three-factor apportionment formula as applied against the tax bases of in-state and out-state taxpayers is not constitutionally different. Like credits or exemptions, the SBT apportionment formula must be condemned for " 'providing a direct commercial advantage to local business'." *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329 (1977) (citation omitted). Additional support for this proposition may be found in *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64 (1963) where this Court observed:

> In each case it is our duty to determine whether the statute under attack, whatever its name may be, will *in its practical operation* work discrimination against interstate commerce.

373 U.S. at 69 (emphasis supplied), *quoting*, *Best & Co. v. Maxwell*, 311 U.S. 454, 455-456 (1940). *See also*, *Westinghouse*, 446 U.S. at 404-405.

In short, the Michigan legislature has adopted an apportionment formula that inexorably skews the tax base in favor of Michigan businesses engaged in interstate commerce over out-of-state businesses engaged in interstate commerce. The three-factor formula systematically underattributes to Michigan the site-specific tax base components—compensation and depreciation—of in-state businesses while systematically overattributing to Michigan those same site-specific tax base components of out-of-state businesses. It accomplishes this result by assigning those tax base components in part on the basis of the taxpayer's sales which effectively export the local taxpayer's SBT base while importing the out-of-state taxpayer's SBT base. Such favoritism of local enterprise, with the concomitant pressure on out-of-state businesses to shift their operations into the state, runs afoul of the bedrock of this Court's Commerce Clause doctrine. *See, e.g., Westinghouse Electric Corp. v. Tully*, 466 U.S. 388 (1984); *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977); *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64 (1962).

As earlier noted, one of the primary reasons Michigan adopted the SBT was to provide incentive for new capital investment in Michigan and "to promote the development and investment of business *within* Michigan." Executive Message of Michigan Governor James J. Blanchard to the Michigan Supreme Court, Pet. App. 79a (emphasis in original).[35] The Michigan Court of Claims has already ruled that the capital acquisition deduction discriminates against out-of-state businesses by providing

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[35] *See also, Analysis of the Michigan Single Business Tax, supra* note 6.

a larger capital acquisition deduction for in-state businesses (those with property and payroll factors that exceed their sales factor) and a lower capital acquisition deduction for out-of-state businesses having identical capital investment in Michigan because their sales factor exceeds their property and payroll factors. *See* note 14, *supra*. No less discriminatory is the incorporation into the Act of an apportionment formula that *underassigns* to Michigan site specific tax base components (compensation and depreciation) of in-state businesses (those with property and payroll factors that exceed their sales factor) and *overassigns* those same site specific tax base components of out-of-state businesses (those with sales factors that exceed their property and payroll factors). In calculating both the capital acquisition deduction and the apportioned tax base, out-of-state businesses are unfairly treated—in one case by receiving the benefit of a lesser deduction; in the other case by receiving a higher assignment of tax base. While the constitutionality of the capital acquisition deduction is not at issue in this case, its discriminatory effect is additional evidence of the legislature's attempt to favor in-state businesses at the expense of out-of-state businesses. Both devices are designed to stimulate, in an impermissible way, capital investment in Michigan in exchange for significant tax benefits. The effect, just as in *Westinghouse Electric Corp. v. Tully*, is to divert new business into the state and to prevent current business from being diverted elsewhere. In sum, the three-factor formula complained of here, just like the capital acquisition deduction, is not "tax neutral." *Boston Stock Exchange*, 429 U.S. at 331; *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 406 (1984).

CONCLUSION

The judgment of the Supreme Court of Michigan should be reversed.

Respectfully submitted,

Of Counsel:

BENJAMIN O. SCHWENDENER, JR.
ALAN M. VALADE
SCHWENDENER & VALADE, P.C.
Dart Management Building
Mason, Michigan 48854
(517) 676-5137

WILLIAM F. SHEEHAN
COLLETTE C. GOODMAN
SHEA & GARDNER
1800 Massachusetts Ave., N.W.
Washington, D.C. 20036
(202) 828-2000

WALTER HELLERSTEIN
Professor of Law
University of Georgia
School of Law
Athens, Georgia 30602
(404) 542-5175

PETER S. SHELDON
(Counsel of Record)
THOMAS D. HAMMERSCHMIDT, JR.
JEFFERY V. STUCKEY
DICKINSON, WRIGHT, MOON,
VAN DUSEN & FREEMAN
215 S. Washington Square
Suite 200
Lansing, Michigan 48933-1812
(517) 371-1730

Counsel for Petitioner

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APPENDIX

APPENDIX

TABLE 4

COMPONENTS OF MICHIGAN TAX BASE

Business Sector	Compensation	% of Column Total	% of Row Total	Business Income	% of Column Total	% of Row Total	Additions	% of Column Total	% of Row Total	Subtractions
Agriculture	$ 126,915,987	0.3	72.1	$ (12,602,299)	(0.4)	(7.2)	$ 71,541,657	0.5	40.6	$ 9,750,533
Mining	219,565,723	0.5	54.6	27,191,969	0.8	6.8	239,722,259	1.7	59.6	84,125,928
Construction	2,131,773,502	4.6	82.5	101,594,020	3.0	3.9	430,399,492	3.1	16.6	78,440,286
Other Durable Manufacturers	3,100,868,105	6.7	77.7	438,663,253	12.8	11.0	638,386,173	4.5	16.0	189,180,129
Non-Durable Manufacturers	3,269,995,332	7.0	66.1	1,003,399,373	29.3	20.3	1,087,689,629	7.7	22.0	411,974,561
Primary Metal Industries	1,353,854,985	2.9	81.7	91,085,053	2.7	5.5	279,344,412	2.0	16.9	66,688,017
Fabricated Metal Products	1,480,260,507	3.2	80.0	171,215,354	5.0	9.3	270,195,376	1.9	14.6	72,247,040
Machinery— Except Electrical	2,201,178,290	4.7	77.7	329,437,362	9.6	11.6	444,475,451	3.2	15.7	141,072,457
Transportation Equipment	10,533,916,766	22.7	94.8	(1,093,328,495)	(32.0)	(9.8)	2,163,536,438	15.3	19.5	497,675,853
Transportation	1,551,436,364	3.3	85.8	(118,151,923)	(3.5)	(6.5)	403,501,511	2.9	22.3	28,858,069
Communications & Utilities	1,392,738,487	3.0	51.4	(20,903,441)	(0.6)	(0.8)	1,385,788,927	9.8	51.1	45,514,715
Wholesale Trade	1,510,291,140	3.3	68.6	442,610,720	12.9	20.1	432,287,622	3.1	19.6	183,159,575
Retail Trade	9,574,169,664	20.6	79.2	890,310,451	26.0	7.4	2,135,508,334	15.5	18.1	555,462,675
Finance Insurance, Real Estate	1,703,262,006	3.7	59.6	(52,666,508)	(1.5)	(1.8)	1,978,897,904	14.0	69.3	773,528,859
Services and Other	6,246,280,456	13.5	67.6	1,222,578,432	35.7	13.2	2,097,690,493	14.9	22.7	330,546,763
All Businesses	$46,396,507,314	100.0	76.7	$3,420,433,321	99.8	5.7	$14,108,965,678	100.1	23.3	$3,468,225,460

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APPENDIX

TABLE 4

COMPONENTS OF MICHIGAN TAX BASE

Business Income	% of Column Total	% of Row Total	Additions	% of Column Total	% of Row Total	Subtractions	% of Column Total	% of Row Total	Total	% of Column Total	% of Row Total
§ (12,602,299)	(0.4)	(7.2)	$ 71,541,657	0.5	40.6	$ 9,750,533	0.3	(5.5)	$ 176,104,812	0.3	100.0
27,191,969	0.8	6.8	239,722,259	1.7	59.6	84,125,928	2.4	(20.9)	402,354,023	0.7	100.1
101,594,020	3.0	3.9	430,399,492	3.1	16.6	78,440,286	2.3	(3.0)	2,585,326,728	4.3	100.0
438,663,253	12.8	11.0	638,386,173	4.5	16.0	189,180,129	5.5	(4.7)	3,988,737,402	6.6	100.0
1,003,399,373	29.3	20.3	1,087,689,629	7.7	22.0	411,974,561	11.9	(8.3)	4,949,109,773	8.2	100.1
91,085,053	2.7	5.5	279,344,412	2.0	16.9	66,688,017	1.9	(4.0)	1,657,596,433	2.7	100.1
171,215,354	5.0	9.3	270,195,376	1.9	14.6	72,247,040	2.1	(3.9)	1,849,424,197	3.1	100.0
329,437,362	9.6	11.6	444,475,451	3.2	15.7	141,072,457	4.1	(5.0)	2,834,018,646	4.7	100.0
(1,093,328,495)	(32.0)	(9.8)	2,163,536,438	15.3	19.5	497,675,853	14.3	(4.5)	11,106,448,856	18.4	100.0
(118,151,923)	(3.5)	(6.5)	403,501,511	2.9	22.3	28,858,069	0.8	(1.6)	1,807,927,883	3.0	100.0
(20,903,441)	(0.6)	(0.8)	1,385,788,927	9.8	51.1	45,514,715	1.3	(1.7)	2,712,109,258	4.5	100.0
442,610,720	12.9	20.1	432,287,622	3.1	19.6	183,159,575	5.3	(8.3)	2,202,029,907	3.6	100.0
890,310,451	26.0	7.4	2,185,508,334	15.5	18.1	555,462,675	16.0	(4.6)	12,094,525,774	20.0	100.1
(52,666,508)	(1.5)	(1.8)	1,978,897,904	14.0	69.3	773,528,859	22.3	(27.1)	2,855,964,543	4.7	100.0
1,222,578,432	35.7	13.2	2,097,690,493	14.9	22.7	330,546,763	9.5	(3.6)	9,236,002,618	15.3	99.9
$3,420,433,321	99.8	5.7	$14,108,965,678	100.1	23.3	$3,468,225,460	100.0	(5.7)	$60,457,680,853	100.1	100.0

TABLE 5

CAPITAL ACQUISITION DEDUCTIONS
FOR
ALL BUSINESSES

Business Sector	Real Property	% of Total	Personal Property After Apportionment	% of Total	Recapture	% of Total	Net	% of Total
Agriculture	$ 7,255,016	0.2	$ 20,334,373	0.2	2,869,598	0.3	$ 24,719,791	0.2
Mining	17,043,446	0.5	87,932,058	0.9	11,363,914	1.3	93,611,590	0.8
Construction	50,627,669	1.6	194,964,270	1.9	27,565,421	3.1	218,245,024	1.8
Other Durable Manufacturers	88,216,943	2.7	393,082,771	3.9	23,692,229	2.7	457,607,450	3.7
Non-Durable Manufacturers	147,853,099	4.5	764,692,618	7.6	23,486,138	2.7	888,883,939	7.2
Primary Metal Industries	19,309,132	0.6	137,690,146	1.4	4,559,948	0.5	152,439,330	1.2
Fabricated Metal Products	35,333,577	1.1	155,313,593	1.5	15,797,645	1.8	174,849,525	1.4
Machinery— Except Electrical	52,435,496	1.6	282,406,626	2.8	30,938,390	3.5	303,903,732	2.4
Transportation Equipment	398,403,847	12.3	3,518,912,702	35.0	43,982,665	5.0	3,873,333,884	31.2
Transportation	33,259,464	1.0	275,299,799	2.7	12,854,094	1.5	295,759,750	2.4
Communications & Utilities	54,596,757	1.7	1,534,200,089	15.3	73,265,270	8.3	1,515,531,576	12.2
Wholesale Trade	62,555,638	1.9	220,911,729	2.2	18,596,229	2.1	264,871,138	2.1
Retail Trade	399,570,484	12.3	1,039,521,534	10.3	181,414,777	20.5	1,257,717,265	10.1
Finance, Insurance Real Estate	1,365,999,848	42.0	386,552,735	3.8	121,415,416	13.7	1,633,160,368	13.1
Services and Other	518,884,063	16.0	1,042,982,428	10.4	292,588,754	33.1	1,269,283,754	10.2
Total	$3,251,344,479	100.0	$10,054,797,471	99.9	$884,390,488	100.0	$12,423,918,116	100.0

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TABLE 8

SINGLE BUSINESS TAX ADJUSTMENTS, 1981

Feature	No. of Businesses	Percent of Businesses [1]	Tax Reductions (Dollars in Millions)
Capital Acquisition Deduction	79,019	60.7%	$312.0
Statutory Exemption	64,636	49.6%	$ 47.0 [2]
Business Loss Deduction	9,702	7.5%	$ 29.5
Labor Intensity Reduction	45,810	35.2%	$162.7
Gross Receipts Reduction	12,153	9.3%	$ 39.9
Small Business Credit	30,464	23.4%	$ 25.6
Unincorporated Business Credit	33,727	25.9%	$ 7.4
Contribution Credit	3,333	2.6%	$ 1.9

[1] Percent of all businesses who filed full SBT returns, including those with zero tax liability.

[2] Minimum: does not include businesses with gross receipts under $40,000, which are not required to file.

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[redacted]

[redacted]

Petitioner,

[redacted]

Respondent.

[redacted]

[redacted]

[redacted]

FRANK J. KELLEY
Attorney General

[redacted]
Solicitor General

THOMAS L. CASEY
Assistant Solicitor General
Counsel of Record
P.O. Box 30212
Lansing, Michigan 48909
(517) 373-1124

RICHARD R. ROESCH
Assistant Attorney General
Attorneys for Respondent

BEST AVAILABLE COPY

QUESTIONS PRESENTED

1. Does Michigan's Single Business Tax Act impose an extraterritorial tax upon Trinova Corporation's activities in violation of the Due Process Clause by employing the evenly weighted three-factor apportionment formula of tangible property, payroll and sales to attribute value added by a unitary multistate business?

2. Does such formulary apportionment of value added constitute economic protectionism designed to benefit instate economic interests by burdening out-of-state competitors in violation of the Commerce Clause?

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CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

In addition to the provisions listed in Pet App 59a, 62a, the Single Business Tax provided in 1980 in pertinent part:

MICH. COMP. LAWS § 208.3(2):

> "'Business activity' means a transfer of legal or equitable title to or rental of property, whether real, personal, or mixed, tangible or intangible, or the performance of services, or a combination thereof, made or engaged in, or caused to be made or engaged in, within this state, whether in intrastate, interstate, or foreign commerce, with the object of gain, benefit, or advantage, whether direct or indirect, to the taxpayer or to others, but shall not include the services rendered by an employee to his employer, services as a director of a corporation, or a casual transaction. Although an activity of a taxpayer may be incidental to another or other of his business activities, each activity shall be considered to be business engaged in within the meaning of this act."

MICH. COMP. LAWS § 208.9

> "(1)'Tax base' means business income, before apportionment, or allocation as provided in chapter 3, even if zero or negative, subject to the adjustments in subsections (2) to (9).

(2) Add gross interest income and dividends derived from obligations or securities of states other than Michigan, in the same amount that was excluded from federal taxable income, less related expenses not deducted in computing federal taxable income because of section 265 of the internal revenue code.

(3) Add all taxes on or measured by net income and the tax imposed by this act to the extent the taxes were deducted in arriving at federal taxable income.

(4) Add, to the extent deducted in arriving at federal taxable income:

(a) Any carryback or carryforward of a net operating loss.

(b) Any carryback or carryforward of a capital loss.

(c) Any deduction for depreciation, amortization, or immediate or accelerated writeoff related to the cost of tangible assets for which a capital acquisition deduction was claimed in any tax year pursuant to section 23, and for the 1976 tax year, 72%, and for the 1977 tax year and subsequent tax years 100% of any deduction for other depreciation, amortization, or immediate or accelerated writeoff related to the cost of tangible assets.

(d) Any dividends paid or accrued except dividends that represent reduction of premiums to policyholders of insurance companies.

(e) Any deduction or exclusion by a taxpayer due to a classification as a domestic international sales corporation, western hemisphere trade corporation, China trade act corporation or any like special classification the purpose of which is to reduce or postpone the federal income tax liability. This subsection shall not apply to the special provisions of sections 805, 815(c)(2)(A), 809, 823(c), and 824(A) of the internal revenue code.

(f) All interest except amounts paid, credited, or reserved by insurance companies as amounts necessary to fulfill the policy and other contract liability requirements of sections 805 and 809 of the internal revenue code.

(g) All royalties.

(5) Add compensation as defined in section 4(3).

(6) Add any capital gains related to business activity of individuals to the extent excluded in arriving at federal taxable income.

(7) Deduct, to the extent included in arriving at federal taxable income:

(a) Dividends received or deemed received, including the foreign dividend gross-up provided for in the internal revenue code.

(b) All interest.

(c) All royalties.

(8) Deduct any capital loss not deducted in arriving at federal taxable income in the year the loss occurred.

(9) To the extent included in federal taxable income, add the loss or subtract the gain from the tax base that is attributable to another entity whose business activities were in this state."

MICH. COMP. LAWS §§ 208.31(2), (4), (5):

"(2) As used in this section 'adjusted tax base' means the tax base allocated or apportioned to this state pursuant to chapter 3 and the adjustments permitted by section 23 and the exemptions permitted by sections 35 and 37. If the adjusted tax base exceeds 50% of the sum of gross receipts plus the adjustments provided in section 23(b) and (d), apportioned or allocated to Michigan with the apportionment fraction calculated pursuant to chapter 3, the adjusted tax base may, at the option of the taxpayer, be reduced by such excess. The taxpayer shall not be entitled to the adjustment provided in section 31(5), (6), or (7) for the same taxable year.

***

(4) The tax so levied and imposed is upon the privilege of doing business and not upon income.

(5) In lieu of the adjustment provided in subsection (2) or (3) a person may elect to reduce the adjusted tax base by the percentage that the compensation divided by the total tax base exceeds 63%. The deduction shall not exceed 37% of the adjusted tax base."

STATEMENT OF THE CASE

THE NATURE OF A VALUE ADDED TAX

A document entitled "Analysis of the Michigan Single Business Tax" prepared by the Taxation and Economic Policy Office of the Michigan Department of Treasury in January, 1985, pages 20-21[1] explains the theory underlying a value added tax:

> "Under the value-added tax concept, the tax base is the difference between the value of the product at sale and the cost of goods purchased from other businesses that went into the product. That difference is the 'value added' to those materials by the production process. A simple example, outlined below, illustrates the value added concept.

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[1]A copy of the entire document has been lodged with the Clerk of the Court, see Petitioner's brief, p 9, n 6.

VALUE ADDED TAX EXAMPLE

Business: Bakery

Costs:
- Labor - Baker, Sales Clerk
- Materials - Flour, Sugar, Spices, Utilities
- Capital - Building, Mixer, Utensils, Oven
- Credit - Interest Paid on Loans

Revenue = Cost Labor + Cost Materials
+ Depreciation + Interest
+ Profit

Value Added = Revenue - Cost Materials
= Cost Labor + Interest + Profits + Depreciation

"In this example, a bakery's costs are for labor, materials, capital goods and credit. The sum of these costs plus the firm's profit equals, by definition, the total revenue or sales of the business. Value-added may be defined as revenue minus materials costs, that is the difference between the sales value of the final product and the value of the goods used in producing the product.

"The next issue for a value-added tax is determining how to calculate the tax base or value added. What the example makes clear is that there are two alternative, but equivalent ways of calculating value added. One alternative is to simply start with sales and subtract material costs. Another way is to add up profits plus labor costs plus interest paid plus depreciation. The important point is that, conceptually, these two calculations are equal. That is,

SALES - MATERIALS = PROFITS + LABOR + INTEREST PAID + DEPRECIATION

"This must be true because it simply is a reorganization of the statement that sales less costs equals profits. Both sides of this equation equal value-added and could be used to calculate the tax base."

The member nations of the European Economic Community employ yet a third method of tax base determination, the invoice-credit method. They administer their VAT[2] as if it were a multi-stage sales tax. The supplier

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[2]VAT will be hereinafter used to refer to the term value-added tax.

of raw material levies the VAT rate on the sales price and bills it to the manufacturer. The manufacturer collects from the wholesaler a VAT on the price of the manufactured product. He reports to the taxing authority the VAT collected and takes a credit for VAT paid to his supplier. In the case of tax audit the supplier's invoice is used to justify the credit. The wholesaler and retailer follow the same course. They collect the VAT on the selling price and remit as tax the difference between the VAT collected from customers and VAT paid to their suppliers.

The computational mechanics of the above methods do not purport to determine the situs and jurisdiction where the value is added. The addition or subtraction method is designed to determine only the incremental value or cost added to a product or service

by business activities. The invoice method used by the European Economic Community directly determines the tax on such value or cost at the point of each sale in the production chain. In each method the geographic location of the components is not a consideration.

All business enterprises combine labor, capital, and managerial skills hoping to produce business income. To turn this hope into reality the goods and services of the enterprise must be marketed. The market, reflecting the preference of consumers, determines the gross income the goods and services command. The gross income realized by the enterprise may be greater than, equal to, or less than its production costs. This is a consequence of a free market system; businesses may temporarily or permanently

fail to generate sales sufficient for those who have contributed labor, capital, or entrepreneurial skills to recover their contribution.

Market prices are indivisible and incapable of reflecting the portion of the price attributable to factors that went into the production of the good or service. Because there is no consistent correlation between the production costs of an enterprise and either its gross income or the payments made to other enterprises, production costs such as compensation and depreciation cannot be used as direct measures of value added.

Since value added is the difference between the gross receipts from the sale of goods and services and the amounts paid to others for goods and services which were incorporated therein, certain attributes of

value added are obvious. First, value added is dependent upon a market. Second, its magnitude is correlated with the gross income which products and services command in the market. Third, goods or services do not contribute to value added until they are sold. Finally, value added is created by two elementary factors: business gross receipts from sale of finished products and material payments to other businesses which supplied the raw material.

THE NATURE OF MICHIGAN'S SINGLE BUSINESS TAX

> "The single business tax is a form of value added tax, although it is not a pure value added tax." Trinova Corp v Treasury Department, 433 Mich 141, 149 (1989) (Pet App 10a)

It is considered not to be a pure value added tax

> " ... because of various exclusions, exemptions, and industry-specific adjustments that were adopted by the

Legislature when the tax was enacted." 433 Mich at 149, fn 6.

Michigan's Single Business Tax, Act 228 of the Michigan Public Acts of 1975; MCL 208.1 et seq, effective January 1, 1976, replaced seven taxes upon business[3]. It also exempted persons subject to the single business tax from the specific tax imposed on intangible personal property by 1939 PA 301; MCL 205.131 et seq; MSA 7.556(1) et seq, and concurrently the ad valorem property tax on inventories was repealed by 1975 PA 234; MCL 211.9c; MSA 7.9(3). Corporations engaged in manufacture and sale of products became sub-

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[3]The domestic building and loan and savings and loan privilege tax; the foreign building and loan and savings and loan privilege tax; the federal savings and loan privilege tax; the domestic insurance company privilege tax; the financial institution income tax; the corporate income tax and the annual corporation privilege (franchise) tax.

ject to a single tax for the privilege of doing business. Prior to 1976 they had been subjected to an annual franchise tax measured by their capital and surplus, i.e., their net worth; an income tax measured by federal taxable income with some modifications; a specific property tax upon their intangibles, mainly stock portfolios and accounts receivable; and an ad valorem property tax upon their inventories.

The net worth franchise tax, the income tax and the intangible property tax each contained a three-factor apportionment formula of property, payroll and destination sales. Michigan's portion of a multistate corporation's net worth, income or intangible property was apportioned by a factor which resulted from addition of the Michigan percentages of a taxpayer's property, payroll

and sales and dividing the aggregate by 3, the number of factors.

The Single Business Tax which was substituted for these separate taxes, retains the identical apportionment formula. It is "a tax upon business activity" and "its intended effect is to impose a tax upon the privilege of conducting business activity within Michigan", (Opinion of Michigan Supreme Court, Pet App 10a). It is measured by modified, apportioned value added which is the difference between the gross receipts from the sale of products and services and the costs of materials purchased from others that were incorporated in the sold products and services.

The SBT employs the addition method of calculating value added which is stated by the equation:

value added = labor costs + interest + profits + depreciation.

As explained by the Michigan Supreme Court (Pet App 11a), the tax base of value added is computed by adding to business income which "is essentially federal taxable income" (the profit element in the equation) a taxpayer's compensation (labor costs), depreciation expense, and the interest, dividends and royalties paid.

The alternative method of value added computation, the subtraction method, representing the equation:

value added = revenue (gross receipts) - material costs

was formerly used by the Michigan Business

Activities Tax,[4] a modified value-added tax which had been in effect from 1953 to 1967. The BAT and the SBT resemble each other in all essential details, are imposed on the identical subject, apportioned by identical 3-factor formula, and even contain similar relief provisions for labor-intensive businesses (the excess compensation reduction). These facial similarities clearly reveal the SBT as a descendant of the BAT.

In "Developments in the Law: Federal Limitations On State Taxation of Interstate

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[4]Robert J. Kleine, The Michigan Single Business Tax: A Different Approach to State Business Taxation, Advisory Commission on Intergovernmental Relations (Washington, D.C. March 1978) where the author states at page 17: "The Michigan Single Business Tax represents a return to the philosophy of business taxation which was in effect in Michigan from 1953 to 1967. In these years, Michigan imposed the business activities tax [BAT] also a form of value-added tax."

Business" 75 Harvard Law Review, 953, 1020 (1960-61), the observation is made that the Michigan Business Activities Tax "seems to fall halfway between the net income and the gross receipts taxes." The article discusses this Michigan tax under the heading of "Value-Added Taxes" at 75 Harvard Law Review 1026, 1027 (footnotes omitted):

> "The Michigan business activities tax is grounded on the assumption that the value which an enterprise adds to the goods and services it sells is the difference between the value of its output, measured by its gross receipts, and the value of the goods it purchases in order to obtain this output.
>
> " ...
>
> "The base of the Michigan tax is derived by deducting from gross receipts all purchases of noncapital assets from other firms, depreciation of real property, interest and rent, and taxes other than income taxes. Unlike a pure value-added tax, depreciation expense of personalty is not deductible, seemingly in order to avoid putting labor at a competitive disadvantage with machinery. A further departure from theory allows a reduction in the tax when net income is low compared to adjusted receipts.

" ...

" ... the Michigan statute employs a three-factor 'Massachusetts-type' apportionment formula. The Michigan Supreme Court, in Armco Steel Corp. v. Department of Revenue, held the tax and its apportionment formula constitutional whether the tax was construed as a net income or a gross receipts tax. The Supreme Court dismissed the appeal."

Armco Steel Corp v Department of Revenue, 359 Mich 430, app dismissed, 364 US 337 (1960), rejects the contention that the relative diminutiveness of the payroll and property fractions when compared to the sales fraction indicates a distortion of the attribution method.[5] The statutory 3-factor for-

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[5]The Michigan Supreme Court noted, 359 Mich at 436, that the taxpayer's Michigan payroll factor was less than 1/10 of 1%, its property factor less than 1/400 of 1% and that Michigan destination sales approximated 8.78% of its total receipts. Trinova's activities in Michigan were somewhat more extensive than those of Armco. Trinova's Michigan payroll factor was less than 1/4 of 1% (.2328%), its property factor less than 1/10 of 1% (.0930%) and its sales factor 26.5892% [Pet brief p 15].

mula attributed to Michigan less than 3% of Armco's "adjusted receipts" (the measure of the tax) for "the privileges, opportunities and protection Plaintiff enjoys in conducting its interstate business in the state" (the subject of the tax) 359 Mich 452. The Court observed that:

" ... this tax on Michigan business activities is arrived at by imposing a rate and applying an apportionment formula to 'adjusted receipts' or 'income' derived from or attributable to Michigan sources. We have previously considered the applicability of the income tax case decisions, on the ground that the extent, character, and details of exemptions and deductions from gross proceeds are not decisive of the question of the nature of the tax. So considered, the case of Northwestern States Portland Cement Co. v. Minnesota, 358 US 450 (79 S Ct 357, 3 L Ed 2d 421), is definitely controlling. ..." (359 Mich 452, 453).

Like the BAT, the SBT cannot be construed as a net income tax or a pure gross receipts tax and should be regarded like the BAT (75

Harvard Law Review, 1020) as conceptually "falling halfway between" such levies.

The business community works with an income continuum that starts with gross income and terminates with net income. The SBT base of (modified) value added lies at the mid-point of this continuum which provides two ways of arriving at value added. One can start at the beginning of the continuum, gross income, and subtract only payments for materials to other businesses which is the subtraction method of value added computation. Alternatively, one can start at the end of the continuum, net income, and add back any deductions made in arriving at net income that are not deductible from gross income when computing value added because they are not payments made for raw materials. This is the addition method of calculation.

It should logically follow that, if apportioned net income or apportioned gross receipts are proper measures for a tax on in-state aspects of a multi-state enterprise, Western Live Stock v Bureau of Revenue, 303 US 250, 255, 256 (1938), then ipso facto such in-state aspects, activities and privileges are also measurable by apportioned value-added.

The similarity between the SBT and a gross receipts tax is illustrated by the optional method of tax computation which is commonly called the "gross receipts method". The SBT provides that "at the option of the taxpayer" the adjusted tax base (against which the 2.35% rate is levied) shall be 50% of apportioned gross receipts. SBTA §31(2) MCL 208.31(2); MSA 7.558(31)(2). As a result, no firm's SBT should ever exceed

1.175% of apportioned gross receipts. Statistics of the Michigan Department of Treasury indicate that more than 12,000 (12%) of approximately 96,000 taxpayers (accounting for about 6% of total SBT revenue) claim the 50% gross receipts reduction.

The data set forth at pages 14-15 of Petitioner's brief and in stipulated facts (Pet App 56a) will serve to illustrate the computational mechanics of the SBT. It brings into focus the addition method of tax-base determination used by the majority (nearly 88%) of taxpayers and the optional method which consists of a 50% reduction of apportioned gross receipts.

Gross Receipts (Total Sales)		$391,065,866
Business Income (U.S. taxable income)	(42,466,114)	
Compensation	226,356,271	
Depreciation	23,262,909	
Interest, Dividends, Royalties Paid	22,908,950	
Other Additions	549,526	
Less Interest, Dividends, Royalties Received	(9,486,223)	
Tax base	$221,125,319	
Apportionment		
Property factor	.0930%	
Payroll factor	.2328%	
Sales factor	26.5892%	
Average factor	8.9717%	x 8.9717%
Apportioned tax base	$ 19,838,700	$ 35,085,256
Less Net Capital Acquisition Deduction	9,064	
Adjusted tax base	19,829,636	
Less 50% of gross receipts		17,542,628
Optional tax base		17,542,628

The foregoing illustration indicates that Trinova could have chosen to apply the tax rate of 2.35% to its optional tax base consisting of 50% of apportioned gross receipts. However, such election would have disqualified it from claiming the "excess compensation reduction" granted by SBTA §31(5), MCL 208.31(5); MSA 7.558(31)(5). Trinova's tax base for 1980 was $221,125,319. Since its compensation ($226,356,271) exceeded the tax base, it was entitled to the maximum reduction of 37% from its apportioned tax base. Such reduction finalized its tax base at $12,492,671 (Petitioner's brief p 15), i.e., at 63% of its apportioned value-added of $19,829,636.[6]

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[6]It is entirely accurate to state that the SBT is imposed on modified apportioned value added which in Trinova's case is 63% of apportioned value added.

THE GENESIS OF THIS CASE

Trinova filed its 1980 SBT return electing the addition method of computing tax liability. The return showed: (i) business income (loss) of $(42,466,114)[7]; (ii) additions to business income of $273,077,656; (iii) deductions from business income of $9,486,223; (iv) a pre-apportionment tax base of $221,125,319; (v) a Michigan apportionment factor of 8.9717%; (vi) a Michigan apportioned tax base of $19,838,700; (vii) deductions for high labor costs and capital acquisitions totaling $7,346,029; (viii) a Michigan adjusted tax base after special deductions of $12,492,671; and (ix) a tax liability of $293,578. (Petitioner's brief pp 14-15).

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[7]Statutory (business income) = federal taxable income.

In 1985 Trinova filed an amended 1980 return and asked for permission to use an alternate method of tax computation consistent with the decision of the Michigan Court of Appeals in Jones & Laughlin Steel Corp v Department of Treasury, 145 Mich App 405 (1985), which cast doubt upon the manner in which the SBT apportionment formula was being applied to out-of-state businesses.

In its amended 1980 return Trinova did not add back any compensation or depreciation to net business income and thereby arrived at a negative amount, $(28,493,861),[8] which it treated as subject to apportionment. It next applied the statutory three factor apportion-

[8]Exclusion of compensation and depreciation ($226,356,271 + $23,262,909 = $249,619,180) converted the positive pre-apportioned tax base of $221,125,319 to a negative pre-apportioned loss of $28,493,861.

ment fraction developed in its original 1980 return, 8.9717%, to this total negative amount to arrive at the Michigan portion thereof, $(2,556,384). To this negative Michigan amount it added: (i) compensation paid in 1980 to its employees for services physically performed in Michigan, $511,774; and (ii) depreciation and amortization incurred in 1980 on its tangible property having a situs in Michigan in the amount of $2,152. These two adjustments brought the total amount Trinova assigned to Michigan, as its apportioned tax base, to a negative, $(2,042,458).

The Commissioner rejected Trinova's request for permission to file on this basis and its claim for refund. Trinova filed an action in the Michigan Court of Claims challenging the determinations of the

Commissioner and the Court of Claims ruled for Trinova (Pet App 42a-51a). The decision was appealed to the Michigan Court of Appeals which reversed the Court of Claims (Pet App 30a-41a) declining to follow the ruling in Jones & Laughlin Steel Corp v Department of Treasury, supra. The case was appealed to the Michigan Supreme Court which sustained the Court of Appeals (Pet App 1a-28a).

SUMMARY OF ARGUMENT

Trinova erroneously contends that the Michigan Single Business Tax violates the Due Process and Commerce Clauses because (i) the principal components of the tax base (compensation and depreciation) can be separately allocated and therefore should not be the subject of apportionment, and (ii) the apportionment formula distorts the amount of

petitioner's tax base attributed to Michigan because of the inclusion of a sales factor in the formula. They further erroneously contend that the SBT violates the Commerce Clause because it discriminates in favor of instate businesses selling their goods out-of-state, as contrasted with out-of-state businesses selling their goods instate.

Trinova's erroneous contentions are based in large part on its misunderstanding of the nature of the SBT and the composition of its tax base. The subject of the SBT justifying its imposition is business activity performed in Michigan or the privilege of doing business. This tax on activities is measured by modified value added. Value added is the difference between the gross receipts from the sale of finished goods and services and the amount paid for raw materials. Mobil Oil

Corp v Department of Treasury, 422 Mich 473 (1985); Trinova Corp v Michigan Department of Treasury, 433 Mich 141 (1989) (Pet App 1a-28a).

The measure of the SBT is computed by adding to federal taxable income (statutorily denominated "business income") the costs incurred in the production of goods and services (compensation, depreciation, interest and royalties paid) and deducting interest, royalties and dividends received. This addition method of value added determination does not convert the SBT from a single tax levied upon value added to a series of distinct taxes upon elements of cost which are fused therein. Trinova is simply wrong in its contention that the SBT tax base consists of specifically identifiable cost items that should be taxed on a separate geographical accounting basis.

Trinova completely overlooks this Court's prior pronouncements that in the case of a unitary business such as Trinova's separate geographic accounting is not constitutionally required because the contribution to value made by such factors as functional integration, centralized management and economies of scale cannot properly be reflected in a separate geographic accounting regime. In other words, the rule set forth by this Court in Container Corp of America v Franchise Tax Board, 463 US 159, reh den 464 US 909 (1983), and Mobil Oil Corp v Commissioner of Taxes, 445 US 425 (1980), is directly relevant and controlling here -- separate geographic accounting is not constitutionally required for state taxation of a unitary business.

The SBT was levied on less than 34% of the value added contained in the products

sold in Michigan by Trinova in the year 1980. This fact negates Trinova's charge that Michigan exerted its taxing jurisdiction over extraterritorial values in violation of the Due Process Clause.

The inclusion of sales in the 3-factor apportionment formula clearly satisfies the tests of internal and external consistency and reflects the importance of market demand to the production of value added. Gross receipts and its derivatives, value added or net income, are not realized until products or services are sold. These measures of business activity are generated by a series of transactions spanning the unitary enterprise of manufacture, distribution and sale. Bass, Ratcliff & Gretton v State Tax Commission, 266 US 271 (1924). The 3-factor UDITPA formula is a "benchmark" for appor-

tionment of value added as well as income. Container Corp; Amerada Hess Corp v New Jersey Department of the Treasury, 490 US __, 104 L Ed 2d 58 (1989).

Whether computed by the addition or subtraction method, value added cannot be split into components or elements of cost and profit. These cost elements, i.e., compensation, depreciation, interest paid, etc., are interdependent, must operate in conjunction and their product must be sold in order to create value added. Separate geographic accounting of these costs which are fused into value added misconstrues the SBT and is not constitutionally required. Mobil Oil Corp v Department of Treasury, supra, 422 Mich 473; Exxon Corp v Wisconsin Dept of Revenue, 447 US 207 (1980); Shell Oil Co v Iowa Department of Revenue, 488 US ___, 102 L Ed 2d 186 (1988); Amerada Hess, supra.

The inability to trace value added to production factors precludes the use of separate accounting to assign amounts of value added to each of the states in which a multistate unitary enterprise operates and warrants resort to formulary apportionment.

The SBT apportionment formula reflects the property, payroll and sales which make possible the addition of value to products. This formula is externally consistent, Container Corp, supra, because it apportions to Michigan an amount that fairly reflects the instate component of the value added by Trinova.

The Commerce Clause does not require the use of any particular formula to apportion value added or income used as a measure of activities attributable to a state. Moorman Manufacturing Co v Bair, 437 US 267 (1978).

Neither does it require fragmenting of value added and separate taxation of its fragments.

Westinghouse Electric Corp v Tully, 466 US 388 (1984); Tyler Pipe Industries, Inc v Washington State Department of Revenue, 483 US 232 (1987); Boston Stock Exchange v State Tax Commission, 429 US 318 (1977); Maryland v Louisiana, 451 US 725 (1981); American Trucking Associations, Inc v Scheiner, 483 US 266 (1987); New Energy Co v Limbach, 486 US ___, 100 L Ed 2d 302 (1988), do NOT deal with the apportionment of multistate values and are not in point. These cases apply the negative aspect of the Commerce Clause which prohibits favoritism of in-state economic interests at the expense of out-of-state competitors and geographic bias of tax exemptions and credits. Trinova's apportionment complaint which itself is premised upon

separate geographic accounting, fails to implicate this aspect of the Commerce Clause.

ARGUMENT

The essence of Trinova's argument is that Michigan's Single Business Tax violates the Due Process and Commerce Clauses because (i) the principal components of the tax base (compensation and depreciation) are capable of being allocated on a separate geographical basis and thus should not be the subject of apportionment, and (ii) Michigan's apportionment formula, because it includes a sales factor, does not reasonably reflect the value added by Trinova in Michigan and therefore produces a "grossly distorted result."

Trinova would have this Court believe that due to the nature of Michigan's Single Business Tax, the issues presented in the

instant case are somehow unique. However, once the labels are stripped away and the nature of the tax is fully understood, it is clear that well established precedents of this Court unequivocally confirm the constitutional integrity of the Michigan tax.

The Constitution imposes "extremely limited restrictions" on a State's power of taxation. Wisconsin v J C Penney Co, 311 US 435, 445 (1940); Northwestern States Portland Cement Co v Minnesota, 358 US 415, 457 (1959). Those restrictions cluster around two related principles: (1) the States are forbidden to impose extraterritorial taxes and (2) they may not impose taxes that discriminate against interstate commerce. Application of these principles requires examination of the "the unique characteristics of the statute at issue and the

particular circumstances in each case." Boston Stock Exchange v State Tax Commission, 429 US 318, 329 (1977).

This Court has evolved two distinct, although somewhat overlapping, tests to evaluate the constitutionality of state taxation of interstate commerce. As a general matter, both the Due Process Clause of the Fourteenth Amendment and the Commerce Clause of Article I, Section 8, preclude the state from taxing "value earned outside its borders." Asarco, Inc v Idaho State Tax Commission, 458 US 307, 315 (1982). This principle requires "a minimal connection" or "nexus" between the interstate activities and the taxing state. Exxon Corp, supra, 447 US at 219; Mobil Oil Corp, supra, 445 US at 436-437.

Additionally, there must exist "a rational relationship" between the measure of

a State's tax "and the intrastate values of the enterprise." Mobil Oil Corp, supra, 445 US at 437; Moorman Manufacturing Co, supra, 437 US at 272-273; Norfolk & Western Railway Co v State Tax Commission, 390 US 317, 325 (1968). The measure of a State's tax should be rationally related to a taxpayer's in-state activities and hence to the protections and benefits afforded by the State. Commonwealth Edison Co v Montana, 453 US 609, 622 (1981); Complete Auto Transit, Inc v Brady, 430 US 274, 279, reh den 430 US 976 (1977).

A tax imposed on a multistate business must consequently be limited to reach only business which is fairly attributable to the State, i.e., the tax must be fairly apportioned. Container Corp, supra, 463 US at 171; Exxon Corp, supra, 447 US at 220;

Complete Auto Transit, supra, 430 US at 279. The Constitution does not require any particular type of formulary apportionment, Moorman Manufacturing Co, supra.

In Container Corp, supra, this Court analyzed the fairness of an apportionment formula in terms of its internal and external consistency, 463 US at 169:

> "The first, and again obvious component of fairness in an apportionment formula is what might be called internal consistency--that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed. The second and more difficult requirement is what might be called external consistency--the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."

The internal consistency of the SBT apportionment formula is conceded. Trinova disputes its external consistency.

I.

THE THREE-FACTOR APPORTIONMENT FORMULA DOES NOT PROJECT THE STATE'S TAXING AUTHORITY BEYOND ITS BORDERS IN VIOLATION OF THE DUE PROCESS CLAUSE.

A. TRINOVA REALIZED VALUE ADDED OF MORE THAN $58,000,000 IN MICHIGAN, MICHIGAN ASSERTED TAXING JURISDICTION OVER LESS THAN $20,000,000 OF SUCH VALUE ADDED AND IT SUBJECTED TO TAX LESS THAN $12,500,000 OF APPORTIONED MODIFIED VALUE ADDED.

The facts in the case at bar establish that in 1980 Trinova had total gross receipts from sale of its products of $391,065,866 (Pet App 56a). Trinova reported $221,125,319 (Petitioner's Brief p 15) or 56.6% of that amount as total or preapportioned tax base. This represents the value added by Trinova's unitary business activities nationwide. Stated another way, on the average, e n dollar of Trinova's gross receipts consisted of 56.6 cents of value added.

In Michigan, Trinova realized gross receipts of $103,981,354 (Pet App 56a) in the year 1980. These gross receipts thus reflect value added of $58,853,446 (56.6%).[9] No constitutionally valid objection could be made if Michigan were to impose a tax upon either such gross receipts or the value added contained therein. General Motors Corp v Washington, 377 US 436 (1964); Standard Pressed Steel Co v Washington Revenue Department, 419 US 560 (1975).

Yet, Michigan's SBT is not aimed at wholesale transactions, traditionally viewed as locale-specific, which would justify such

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[9]It is a fair assumption that the gross proceeds from Trinova's automobile components, primarily window glass delivered to the automotive plants of GM (and other manufacturers) located outside of Michigan and the gross proceeds from Trinova's product delivered to the plants in Michigan contain a similar percentage of value added.

taxation. It is imposed on business activities "within this state, whether in intrastate, interstate or foreign commerce" SBTA §3(2), MCL 208.3(2).[10]

In recognition of the fact that the $58,853,446 of value added inherent in the products sold by Trinova in Michigan was generated not merely by the demand of the Michigan market, but also by productive capital and labor, Michigan employs a 3-factor formula to determine its share of

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[10]Moorman Manufacturing Co, supra, 437 US 267 (1978), might be read as validating a tax on values generated by multistate activities measured only by sales. However, such a reading would be inaccurate. Moorman, decided by its majority on due process grounds specifically held that a one-factor sales formula does not necessarily--and in the case of Moorman Manufacturing Company did not--violate due process by reaching values (income) out of all appropriate proportion to the intrastate activities of a multistate taxpayer.

this value added. The 3-factor formula assumes that capital, labor and market demand contribute equally to sales price or gross receipts.[11] Logically, therefore, these three factors may also be assumed to contribute equally to any derivative of gross receipts, whether it be net income or value added.

It follows that the $58,853,446 of value added reflected by the Michigan sales should be shared by the jurisdictions in which the contributing property and payroll expense is incurred. Michigan, the market state, laid claim only to slightly more than 1/3 of this value added of $58,853,446 by apportioning

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[11]Although the one-third-each weight given to the three factors is essentially arbitrary " ... the three-factor formula ... has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated." Container Corp, supra, 463 US at 183.

$19,838,700 of such value added (Petitioner's brief, p 15) or approximately 33.71% of the value added contained in the products sold in Michigan[12]. From this sum of $19,838,700 Trinova deducted $9,064 as net capital acquisition deduction and the remainder of $19,829,636 was reduced by 37%, the excess compensation reduction, to arrive at apportioned modified value added of $12,492,671. The rate of 2.35% applied to this base yielded a 1980 tax of $293,578.

B. VALUE ADDED IS GENERATED BY A SERIES OF TRANSACTIONS SPANNING THE UNITARY ENTERPRISE OF MANUFACTURE, DISTRIBUTION AND SALE OF PRODUCTS.

As noted above, this Court has never interpreted the Due Process and Commerce

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[12]$58,853,446 x 33.71% = $19,839,496. Application of the average apportionment factor of 8.9717% to Trinova's total value added of $221,125,319 resulted in an apportioned tax base of $19,838,700.

Clauses to require the use of any particular type of formulary apportionment. It has upheld the use of a one-factor property formula to apportion "net profits", Underwood Typewriter v Chamberlain, 254 US 113 (1920); a one-factor sales formula to apportion net income, Moorman Manufacturing Co, supra; and a single-factor gross receipts formula to attribute net worth (capital and surplus) Ford Motor Co v Beauchamp, 308 US 331 (1939). In Moorman, supra, the court refused to mandate a uniform apportionment formula noting that such mandate was within the power granted to Congress by the Commerce Clause, (437 US 277-280).

Trinova does not contest the fact that it is a unitary business, and it acknowledges (brief p 27) that income arising from multi-state activities of a unitary business is an

"appropriate subject for apportionment." It raises no objection to the use of a 3-factor formula to apportion net income (or loss), but it brands as unconstitutional the "inclusion of the sales factor" to apportion total value added.

Trinova argues that the Constitution requires that value-added taxes be fragmentized and that "tax base components" be separately allocated. If Trinova's erroneous arguments are accepted, the Single Business Tax would be converted to a series of separate taxes upon the elements which are transformed into value added. Alternatively, Trinova contends that this Court should interpret the Constitution to require 2-factor (property and payroll) apportionment of value added if, indeed, value added is an amalgam created by fusion of factors repre-

senting business activities which add cost to purchased material. On page 34 of its brief, Trinova presents an example of such two-factor apportionment and arrives at an apportioned tax base of $360,213. To complete the example, we may subtract the capital acquisition deduction of $9,064 and arrive at an adjusted apportioned tax base of $351,149 which is subject to further diminution by the excess compensation reduction (37% of $351,149) of $129,925. The final adjusted tax base of $221,224 multiplied by the tax rate of 2.35% would result in SBT of $5,199 for the privilege of doing business in Michigan which yielded $103,981,354 (Pet App 56a).

While the 3-factor apportionment formula is today accepted as a "benchmark" for attribution of multistate-generated income, the

inclusion of the sales factor in the income tax apportionment formulas was similarly criticized as late as 1960.[13] Some economic theorists insisted that income was the product of capital and labor and that the marketplace contributed nothing to the income production; it merely portrayed an "exchange of value."

Yet, this view was rejected by the drafters of the Uniform Division of Income for Tax Purposes Act (UDITPA), approved by the House of Delegates of the American Bar Association in 1957. This model act, designed for allocation and apportionment of income from multi-state business, adopted the

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[13]Harriss, Economic Aspects of Interstate Apportionment of Business Income, 37 Taxes, 327, 362-363 (1959); Studenski, The Need for Federal Curbs on State Taxes on Interstate Commerce: An Economist's Viewpoint, 46 Va Law Rev 1121, 1131-1132 (1960).

evenly weighted 3-factor formula of property, payroll and destination sales.

The rejected theory which equates the production of income exclusively with utilization of capital and labor and refuses to consider the participation and importance of market demand is resurrected in argument against 3-factor apportionment of value added (Pet brief p 34). It does not gain logical acceptability by redirecting its thrust. Apportionment of gross receipts and its

derivatives, net income or value added,[14] is best accomplished by giving weight to market demand (sales) as well as the productive factors of capital and labor, i.e., property and payroll.

Trinova repeatedly claims that value added can be measured solely by such internal costs as depreciation and compensation. This amounts to the assertion that economic events

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[14]The starting point in the computation of corporate taxable income are gross receipts which, by deduction of the cost of goods sold and/or operations, is transformed into gross profit. Thereafter, by addition of income items and deduction of expense items, it is converted to taxable income. Similarly, value added is derived by deducting material costs from gross receipts. In Mobil Oil Corp v Department of Treasury, supra, 422 Mich at 493, the Michigan Supreme Court noted that:

> "In the end, the income tax and the VAT tax the same things, but at different stages of the economic process, and thus generate the same amount of revenue and affect the economy identically."

that precede a sale, i.e., the incurring of internal costs, will predict the economic results of the sale that may subsequently occur. There is nothing in the record to support this proposition or the premise that the internal production costs incurred by an enterprise will increase, by a like amount, the prices and the value added that the goods and services of the enterprise will command in the market.

When an enterprise markets its products, consumer preferences, not production costs, determine the prices for which the products can be sold and the gross income the enterprise realizes. There is no assurance that the goods and services which a business sells will command prices that cover the cost of producing them.

Market prices show the value consumers place on the entire goods or services, not on

any of the individual elements that were combined in their production. Because of this indivisibility, precise information about an internal production cost cannot be translated into information about the value or gross income the enterprise may realize from sales. For example, labor costs can be precisely accounted for, but the influence of these costs on the market prices commanded by the goods produced by that labor, and thus the value added by that labor, cannot be ascertained. Value added, like net income, cannot be precisely divided between the factors that contributed to its generation.

The point is best illustrated by Trinova's own situation in 1980. For that year, its total preapportionment "value added" tax base (before special adjustments) was admittedly $221,125,319 as computed under

the Michigan statute. Yet its total compensation for the year was $226,356,271, and its combined total compensation and depreciation costs were $249,616,180, both well in excess of Trinova's admitted "value added" tax base of $221,125,319. Obviously, therefore, Trinova's 1980 costs that were added back under the "additive" method of computing value added did not by themselves establish the measure of Trinova's 1980 value added. Rather, the market presumably concluded that the value added by Trinova to its finished goods was less than the costs it incurred in the production process.

Just like income or gross receipts, value added is an amorphous concept and "arriving at precise territorial allocations of 'value' is often an elusive goal, both in theory and practice," Container Corp, supra, 463 US at 164.

Similarly in Butler Bros v McColgan, 315 US 501, 507 (1941), the Court said that separate accounting "does not prove appellant's assertion that extraterritorial values are being taxed," and in Amerada Hess, supra, 104 L Ed 2d at 67, the Court cited Container Corp and said, " ... the costs of a unitary business [what Trinova claims comprises the SBT tax base] cannot be deemed confined to the locality in which they are incurred."

C. THE SINGLE BUSINESS TAX REFLECTS A REASONABLE SENSE OF HOW INCOME IS GENERATED BY TRINOVA'S UNITARY ENTERPRISE AND PRODUCES A FAIR APPORTIONMENT OF VALUE ADDED.

In Complete Auto Transit, supra, 430 US 274, this Court sought to reconcile the demand that multistate business pay a fair share of state taxes with the need for a nationwide free trade area. It enunciated a

four-part test to judge the constitutional validity of state taxes imposed on multistate activities: Substantial nexus, fair apportionment, nondiscrimination against interstate commerce and a fair relationship of benefits provided by the state and the tax burden.

Trinova does not dispute that its Michigan activities supply the requisite nexus justifying exertion of the state's taxing power. Furthermore, it is uncontroverted that the "advantages provided by the state which aid appellants' business" Amerada Hess Corp, supra, 104 L Ed 2d 58, are fairly related to its tax burden. However, Trinova charges that the SBT does not fairly apportion value added by its unitary multistate business.

This charge of unfair apportionment is premised upon a misconception of the nature

of a value added tax as a series of taxes on separate elements of production costs plus profit. The SBT method[15] for determination of value added identifies cost elements and profit, but does not and clearly was not intended to assign a specific situs to the elements. Trinova's argument which ascribes such a function of geographic allocation to the addition method would render the entire concept of apportionment meaningless.

Trinova's claim of unfair apportionment is based upon a misconception of the nature

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[15]In A Proposal For A Michigan Value Added Tax, James Haughey, Department of Management and Budget, State of Michigan, December 27, 1974, notes that it would "be possible to calculate the tax by subtracting from sales the purchases made from other taxable firms. This was the approach of the Michigan BAT. However, several of the state's major taxpayers report that they used the addition method for the BAT tax anyway because it was easier and conformed more closely with the accounts and concepts required for federal income tax purposes." Appendix A6 of Amicus Curiae Caterpillar Inc.

of value added in the context of a unitary business. A unitary business of manufacture, distribution and sale adds value to its product by all of its operations, i.e., manufacturing, distributing, selling. Thus, neither its income nor the value added to its product is capable of geographic sourcing or attribution. These values are created by a series of integrated activities and realized only by sale of products, Bass, Ratcliff & Gretton, supra, 266 US 271, 282. They are properly divisible by the SBT's three-factor apportionment formula of property, payroll and sales among the jurisdictions wherein the value-adding or income-producing activities take place.

Trinova's characterization of the SBT as an "origin-principle" VAT is inaccurate. As explained by Trinova (brief p 6) the

"destination" label is applied to the national VATs of the European Economic Community. To encourage exports they rebate VAT on products which are exported, but impose their VAT rate against the total price of products sold. Consequently, value added at all stages in the production chain, whether in foreign countries or domestically, is subjected to tax in the consumer (destination) country. Obviously, if a State of the United States were to adopt such scheme of taxation, it would be challenged as an unapportioned tax on value added by multistate activities. It could only be defended as a state tax upon locale-specific sales transactions.

Constitutional problems would likewise arise if a state were to adopt a pure "origin-based" VAT and subject exports to tax

while exempting imports. Maryland v Louisiana, 451 US 725 (1981). Origin or destination principle VATs are premised upon allocation, not apportionment, of value added. Michigan's SBT, by contrast, is measured, in the case of multistate business, by apportioned (modified) value added. If there be need for such categorization, it might be labelled as a "neutrally based" VAT.

Regardless of labels, this Court has insisted that the formulary apportionment of multistate and multinational activities, privileges, and property should only be applied to "unitary" values. As stated in Mobil Oil Corp, supra, 445 US at 439, the unitary-business principle is "the linchpin of apportionability."

This Court has long and consistently recognized that if a business is unitary, it

is impossible as a practical and perhaps even theoretical matter, to determine the geographic or functional source of particular values. All activities of an integrated business make some contribution to the production of income, to the net worth of the business and, we submit, to value added. Container Corp, 463 US at 164, 165; Butler Bros, supra, 315 US at 506, 507; Bass, Ratcliff & Gretton, supra, 266 US at 282.

This Court has traditionally focused upon the Due Process Clause in determining the validity of formulary apportionment. To sustain a claim of unconstitutional apportionment a taxpayer must produce "clear and cogent" evidence that the multistate value attributed by the state apportionment formula was "out of all appropriate proportion to the actual business transacted" in the state.

Butler Bros, supra, 315 US at 507; Hans Rees' Sons v North Carolina, 283 US 123, 135 (1930); Moorman Manufacturing Co, supra, 437 US at 274; Exxon Corp, supra, 447 US at 220.

Trinova apparently believes that the Michigan tax on value added is so different from a tax on net income that the justification set forth in cases like Mobil for rejecting a requirement of separate geographical accounting is simply inapposite here. But the basis for this Court's position in Mobil is not that separate accounting is inappropriate for an income tax, but that it is inappropriate for a unitary business. Michigan submits that for purposes of determining whether separate geographical accounting must be utilized by a state seeking to tax a unitary enterprise engaged in business activity within its borders there

is no constitutional difference between an income tax and a value added tax.

In Mobil, supra, 445 US at 438, the Court noted:

> "--separate accounting, while it purports to isolate portions of income received in various states, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale."

The Court then concluded that since:

> "...such factors arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.'"

In Exxon Corp, supra, 447 US at 229-230, the Court concluded:

> "In short, the Commerce Clause does not require that any income which a taxpayer is able to separate through accounting methods and attribute to exploration and production of crude oil and gas be allocated to the states in which those production centers are located. The geographic location of such raw materials

> does not alter the fact that such income is part of the unitary business of the interstate enterprise and is subject to fair apportionment among all states to which there is a sufficient nexus with the interstate activities of the business."

Here, that portion of value added which Trinova by separate accounting seeks to exclude from its products sold in Michigan is produced by unitary multistate activities and is subject to fair apportionment which reflects a reasonable sense of how its income is generated. The rule set forth by this Court in Container Corp and Mobil is directly relevant and controlling here--separate geographical accounting is not constitutionally required for state taxation of a unitary business.

On three occasions this Court struck down state tax apportionment methods as applied to unique individual circumstances. In Union

Tankline Co v Wright, 249 US 275 (1919), the Court held that a mileage apportionment formula which attributed to Georgia's taxing jurisdiction approximately six times the value of mobile property actually located in the state was:

> " ... an arbitrary method which produced results wholly unreasonable, and that to permit enforcement of the proposed tax would deprive it of property without due process of law and also unduly burden interstate commerce." 249 US 283.

In Hans Rees' Sons, Inc, supra, 283 US 123, the Court invalidated a four-fold attribution of income to North Carolina which resulted from a one-factor apportionment formula consisting of property. In Norfolk and Western Railway Co, supra, 390 US 317, the court invalidated the apportionment of systemwide property value by a one-factor mileage formula which resulted in attribution

of value 2 and 1/2 times of actual undisputed inventory.

Similarly, in Mobil, Exxon, Amerada Hess, and Shell Oil Co, supra, 102 L Ed 2d 186, the taxpayers pressed their own individual case insisting that the apportionment formula as applied to their circumstances reached a constitutionally impermissible result. The main thrust of argument in these cases was aimed at the due process restrictions upon state taxing authority, the limitation of taxing jurisdiction and the prohibition to project it beyond the state's borders.

In Moorman, supra, equal emphasis was shifted to a Commerce Clause analysis. The single factor sales formula was assailed as economic protectionism, a tariff on goods manufactured in other states and a subsidy to Iowa manufacturers. The Court was asked to

decree that the formula was invalid as an impediment of or discrimination against non-domiciliary business in violation of the Commerce Clause. Further or alternatively, the Court was requested to find that Iowa's apportionment formula projected its taxing power upon extra-territorial values in violation of the due process rights of Moorman Manufacturing Company.

A majority of the Court decided the case on due process grounds and ultimately found no convincing evidence of extraterritorial taxation by Iowa of Moorman's multistate income. A minority of the Court employing a Commerce Clause analysis proposed to condemn the Iowa single-factor formula, although Mr. Justice Blackmun's dissent agrees "that application of Iowa's formula does not violate the Due Process Clause." 437 US 286.

Trinova and a host of litigants in the Michigan courts[16] argue that the Constitution requires that multistate value added be attributed by separate accounting of its site-specific components, i.e., compensation, depreciation, royalties paid, etc. They present no evidence of extraterritorial taxation; they simply assert that value added must be split into its basic elements and that these elements be separately exposed to taxation.

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[16]At the present time there are pending 471 cases with an amount of tax in controversy in excess of $145,000,000 plus an indeterminate amount of interest.

II.

THE APPORTIONMENT OF VALUE ADDED BY A THREE-FACTOR FORMULA OF PROPERTY, PAYROLL AND SALES DOES NOT DISCRIMINATE AGAINST OUT-OF-STATE BUSINESSES AND THE COMMERCE CLAUSE DOES NOT MANDATE FISSION OF VALUE ADDED AND SEPARATE TAXATION OF ITS FRAGMENTS.

Trinova invokes the Commerce Clause to escape from the yoke of taxation upon its modified value added. It charges that the SBT apportionment formula imposes a heavier burden on out-of-state businesses that compete in an interstate market than it imposes on Michigan-domiciled business which also engages in interstate commerce.

Trinova has offered no credible evidence to sustain its charge. Trinova's discrimination argument is premised upon its misconstruction of the SBT as a tax upon compensation and depreciation. Amici Alcan Aluminum Corporation, et al, and Caterpillar

characterize the SBT as "a tax on compensation and depreciation" (Alcan brief p 13) and "a tax on labor" (Caterpillar brief p 16). These characterizations are at odds with the professed legislative objective of stimulating the development and investment of business within Michigan (Pet App 73a). A tax on payrolls would penalize job creation in Michigan.

On page 39 et seq of its brief, Trinova purports to compare the SBT liability of a Michigan business and an Ohio business. However, that comparison is not of SBT burden; it compares a hypothetical tax on compensation, not a tax on value added. The Michigan business with an average apportionment factor of 85 1/3%

$$\frac{\text{property} + \text{payroll} + \text{sales}}{3} = \frac{98\% + 98\% + 60\%}{3}$$

will apportion to Michigan $1,280,000 of its

$1,500,000 total value added.[17] The Ohio business with an average apportionment factor of 14 2/3% ($\frac{2\% + 2\% + 40\%}{3}$) will apportion $220,000. If there are no additional modifications (such as capital acquisition deduction and recapture, excess compensation reduction) the apportioned value added of the Michigan business, at a tax rate of 2.35% will result in an SBT liability of $30,080 whereas the Ohio business will have an SBT liability of $5,170.

While the validity of a state tax on multistate business does not depend upon the operative effect of taxes levied by other jurisdictions in which the business operates, Moorman Manufacturing Co, supra; New Energy

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[17] $1,500,000 = total (pre-apportioned) tax base = total (pre-apportioned) value added.

Co v Limbach, 486 US ____, 100 L Ed 2d 302 (1988), it should not escape attention that the hypothetical Michigan business is also subject to an Ohio tax upon 21% of its total income, whereas the Ohio business apportions 79% of its income to Ohio. This results from Ohio's use of a four-factor income tax apportionment formula [Ohio Rev. Code, sect. 5733.05(B)(2)] consisting of one factor for property, one factor for payroll and two factors for sales.[18]

Thus, the Michigan business is subjected to taxation of 85 1/3% of its value added and 21% of its income; the Ohio business to taxa-

---

[18]The Michigan business is subject to apportionment of $\frac{2\% + 2\% + 40\% + 40\%}{4} = \frac{84\%}{4} = 21\%$

The Ohio business is subject to apportionment of $\frac{98\% + 98\% + 60\% + 60\%}{4} = \frac{316\%}{4} = 79\%$

tion of 14 2/3% of its value added and 79% of its income.

The Michigan tax is imposed "upon the privilege of doing business" [SBTA sec 31(4); MCL 208.31(4)]; the Ohio tax "for the privilege of doing business in this state" [Ohio Rev. Code 5733.01(A)]. The allocation and apportionment provisions of both taxes are designed to fairly "represent the extent of the taxpayer's business activity in this state" [Ohic Rev. Code 5733.05(B)(2)(d) and SBTA sec. 69; MCL 208.69]. Since both value added and income are employed to reflect proportional activity, it can be argued that the hypothetical Michigan business must pay tax on 106 1/3% of its activities and the Ohio business only on 93 2/3% of its activities.

In General Motors Corp v District of Columbia, 380 US 553 (1965), the Court

invalidated a regulation promulgated by the District tax commissioners which provided that the District's franchise tax measured by net income should be apportioned by a single factor sales formula. While the case involved the validity of an administrative regulation, and does not turn on the due process analysis employed in decision of state tax apportionment cases, its rationale is compelling. The Court stated, 380 US at 559:

> "The great majority of states imposing corporate income taxes apportion the total income of a corporation by application of a 3-factor formula which gives equal weight to the geographical distribution of plant, payroll, and sales."

At 380 US 561, 14 L Ed 2d 73, 74, the Court explains further:

> "The standard 3-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the source of costs which it generates. By

> contrast, the geographic distribution of a corporation's sales is, by itself, of dubious significance in indicating the locus of either factor."

The apportionment formula of the SBT does not favor Michigan-domiciled industry. Favorable accommodation of domestic business as accomplished by apportionment methods, such as the employment of four-factor formulas[19] or a single-factor sales formula (as employed by Iowa) is foreign to Michigan tax law which has always sought neutrality of tax burden for multistate firms regardless of

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[19]Nine states use a 4-factor or "double-weighted sales factor" formula: Florida, Illinois, Kentucky, Massachusetts, New York, North Carolina, Ohio, West Virginia, and Wisconsin. CCH Multistate Corporate Income Tax Guide, ¶146. Such formulas may reflect the economic theory which gives equal weight to supply and demand in achieving price levels. It can be argued that the magnitude of gross receipts, income or value added is dependent, to an equal degree, upon supply (property and payroll) and demand (sales).

their business domicile. Such neutrality is best achieved "in the context of general use of the three-factor approach," General Motors Corp, supra, 380 US at 559, by the standard 3-factor apportionment formula employed by the SBT to apportion value added.

Respondent also notes that statistical data does not support Trinova's charge of discrimination. Analysis Of The Michigan Single Business Tax, supra, at p 7 concludes: "For all businesses together, single business taxes average about 0.4 percent of sales... . In other words, the SBT takes, on average, less than one-half of 1-cent per dollar of sales..."

Trinova had Michigan sales of $103,981,354 (Pet App 56a) and an SBT liability of $293,578 (Petitioner's brief, p 15). Consequently, Trinova's SBT liability amounts

to 0.285 percent of its Michigan sales which is but two-thirds of the average tax burden for all single business taxpayers.

The three-factor apportionment formula of the single business tax does not discriminate against out-of-state businesses. It treats both local and foreign concerns with an even hand., Trinova's "discrimination" claim vanishes with its underlying premise that the Constitution requires the "sourcing" of elements which, by unitary multistate activities, are fused into value added.

The SBT is a tax upon business activities measured by modified value added. It assumes that value is added to a product by three major factors; capital, labor, market demand, i.e., property, payroll and sales. Consequently, value added to a product which is produced and sold in different taxing

jurisdictions is subjected to apportionment by these factors.

Trinova argues that apportionment of value added is neither necessary nor constitutionally acceptable. Its separate accounting theories, it is argued, can identify the "sources" of value added and can precisely allocate portions or elements of value added to specific jurisdictions.[20]

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[20]Trinova's citation of authority (Pet brief p 26) is wrong as to form, authoriship, premise and substantive conclusion. The quote is from Michigan's Fiscal and Economic Structure; Chapter 22, the Single Business Tax; pp 673-719, 704, authored by Robin Barlow, a professor of economics and Jack S. Connell, Jr., an undergraduate student in economics at the University of Michigan. It is premised on the mistaken notion that the SBT taxes economic "inputs", i.e., imposes distinct levies upon costs which in conjunction with profits equate value added. It professes a preference for separate accounting over essentially arbitrary and inexact apportionment and concludes that formulary apportionment should not include a sales factor because sales "are not a component of value added."

Similar argument was rejected by this court in Mobil Oil, supra, Exxon, supra, Shell Oil, supra, Amerada Hess, supra and Butler Bros, supra.

In Shell Oil Co, supra, 102 L Ed 2d 186, the Court upheld the inclusion of income derived from outer continental shelf activities within the unitary (pre-apportioned) tax base of Iowa's income tax. It rejected Shell's argument that revenues derived from oil and gas production on the outer continental shelf, far distant from Iowa, should be attributed to their source. The Court stated, 102 L Ed 2d at 199:

> "Shell's argument hinges on the mistaken premise that including OCS-derived income in the pre-apportionment tax base is tantamount to the direct taxation of OCS production. But income that is included in the pre-apportionment tax base is not, by virtue of that inclusion taxed by the State. Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be attri-

butable to Iowa's taxing jurisdiction is taxed by Iowa. As our commerce clause analysis of apportionment formulas has made clear, the inclusion of income in the pre-apportioned tax base of a state apportionment formula does not amount to extraterritorial taxation. This Court has repeatedly emphasized that the function of an apportionment formula is to determine the portion of a unitary business' income that can be fairly attributed to instate activities. Exxon Corp v Wisconsin Department of Revenue, 447 US 207, 219 (1980); Mobil Oil Corp v Commissioner of Taxes, on remand, 445 US 425, 440 (1980)."

The opinion in Amerada Hess, supra, commences with the following recital of fact:

"Appellants in this litigation are 13 major oil companies that do business in the state of New Jersey. They are subject to New Jersey's corporation business tax. They also are subject to the federal windfall profit tax imposed on producers of crude oil. None of appellant's oil production takes place in New Jersey.

Each appellant has sought to deduct its federal windfall profits tax in calculating 'entire net income' for purposes of the New Jersey corporation business tax." 104 L Ed 2d 64.

The taxpayers argued that the federal windfall profit tax was a cost so closely

associated with oil production at the wellhead that it could not be associated with their "unitary business" or "unitary income." In other words, the taxpayers argued that the windfall profits tax was site-specific and isolated to the oil-producing states; that it could not be considered by New Jersey in determining what proportion of their unitary activities and income was subject to taxation by the state.

The Court analyzed these constitutional objections, testing them against the "four prongs of the Complete Auto test." 104 L Ed 67. It first found that New Jersey had a substantial nexus with the activities that generated appellant's entire net income, including all production occurring entirely outside the state. Secondly, it found that New Jersey imposed upon the oil companies a properly apportioned tax and employed

> " ... an apportionment formula that averages the percentages of instate property, receipts and payroll ... we have expressly approved this apportionment formula in the past. See, e.g., Container Corp of America v Franchise Tax Board, 463 US 159, 170 (1983). Indeed this 3-factor formula 'has become ... something of a benchmark against which other apportionment formulas are judged.'" 104 L Ed 2d 67.

Next, the Court found that the tax (its jurisdiction validated by substantial nexus and being fairly apportioned) did not discriminate against interstate commerce. It was neither facially nor impliedly discriminatory against out-of-state industry. Finally, the Court found that police and fire protection, the benefit of a trained work force and the advantages of a civilized society were guaranteed by the laws of New Jersey and were benefits fairly related to the burden of taxation, and the tax paid by the oil companies was "related to the advantages provided by the state which aid (each) appellant's business". 104 L Ed 2d 67.

The principles of Shell Oil and Amerada Hess should be applied with equal force to Michigan's SBT and the facts of this case.

The cases cited by Trinova in support of its discrimination argument deal, as acknowledged on page 42 of its brief, with "tax credits and tax exemptions which favored local business." In these cases the court invoked the Commerce Clause to prohibit designed geographical bias favoring domestic business to the detriment of out-of-state business. By contrast, in its decisions dealing with apportionment of multistate values, the court has traditionally employed a due process analysis.

Westinghouse Electric Corp, supra, 466 US 388, involved a credit for exports shipped

from the state; Tyler Pipe Industries, Inc, supra, 483 US 232, involved a tax credit for local manufacturers; Boston Stock Exchange, supra, 429 US 318, dealt with a 50% tax reduction for sale and transfer of stock within the state; Maryland v Louisiana, supra, 451 US 725, invalidated a natural gas tax from which instate users were partially exempt; and in American Trucking Associations, Inc, supra, 483 US 266, a commercial advantage was given to local truckers by imposition of a flat rate unapportioned axle tax. In New Energy Co, supra, 100 L Ed 2d at 308, the Court held that "the Commerce Clause prohibits economic protectionism--that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors." The case dealt with a sales tax credit available only for ethanol produced in Ohio or a state with a similar reciprocal credit.

The SBT apportionment provisions, unlike the tax credits and exemptions involved in the foregoing cases (or unlike an unapportioned tax), do not reflect geographical bias. To the contrary, the activities of multistate business reflected by value added are attributed to Michigan by geographically neutral comparisons of property, payroll and sales. It is Trinova and its Amici which insist on geographically biased accounting for value added by seeking to allocate compensation and depreciation.

Trinova mentions the capital acquisition deduction of the SBT and litigation concerning its constitutionality in footnote 14 and on page 44 of its brief. It states that the "discriminatory effect" of the capital acquisition deduction (which is not at issue in this case) evidences a legislative

"attempt to favor instate businesses at the expense of out-of-state businesses." Trinova's effort to expand this case beyond its record is unworthy of extended comment.[21]

Similarly, Trinova's implication that the SBT was intended and designed to systematically reduce the tax burden of local business at the expense of out-of-state businesses (Petitioner's brief pp 38, 39) and the implied suggestion that the SBT is being "exported" i.e., its burden shifted to taxpayers outside the state (Petitioner's brief p 43) deserve only summary response.

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[21]The state's brief in Caterpillar, Inc v Michigan, Michigan Court of Appeals No. 119548 focuses upon New Energy Co, supra, Scheiner, supra, Tyler Pipe Industries, Inc v Washington State Department of Revenue, supra, Westinghouse v Tulley, supra, Maryland v Louisiana, supra, Boston Stock Exchange, supra.

There exists no proof that the SBT favors local business aside from the imaginative but falsely-premised separate accounting theories of Trinova. Its SBT burden places a charge against Trinova's Michigan gross receipts which is only two-thirds of the average charge against gross receipts of single business taxpayers as a whole.

There exists an identical lack of proof that the SBT is being "exported" and the implied claim of exportation is similarly premised upon Trinova's separate geographic accounting theories. It is untenable since "the borders between the States are essentially irrelevant" to the SBT burden, Commonwealth Edison Co v Montana, 453 US 609, 619 (1981); and the SBT respects the area of free trade among the several States which is secured by the Commerce Clause. McLeod v J.

E. Dilworth Co, 322 US 327, 330 (1944); Commonwealth Edison Co v Montana, supra.

CONCLUSION

Mr. Justice Frankfurter, recognizing the limited function of the courts, wrote in Wisconsin v J C Penney Co, 311 US 435, 445 (1940):

> " ... At best, the responsibility for devising just and productive sources of revenue challenges the wit of legislators. Nothing can be less helpful than for courts to go beyond the extremely limited restrictions that the Constitution places upon the states and to inject themselves in a merely negative way into the delicate processes of fiscal policy making. We must be on guard against imprisoning the taxing power of the states within formulas that are not compelled by the Constitution but merely represent judicial generalizations exceeding the concrete circumstances which they profess to summarize."

Prior to 1976, the State of Michigan imposed a variety of business taxes. The

most important of these, the corporate income tax was unpredictably cyclical; the personal property tax on inventories was an anachronism; and a variety of privilege taxes including the corporate franchise tax were administratively burdensome to both taxpayer and taxing authority. Thus, the Michigan Legislature replaced these taxes in 1976 by the Michigan Single Business Tax. This tax reform and simplification merged several subjects of taxation into a single tax on the privilege of doing business.

The Michigan SBT is a modified value added tax. It is designed to capture for taxation the value or cost added to a product or service by a taxpayer's business activities. Because of the business community's familiarity with federal income tax law, it was decided to provide for an addition rather

than subtraction method of determining value added. Thus, a taxpayer's tax base is computed by starting with its net income from all operations and then adding total compensation, depreciation, royalties paid, interest paid, all of which reflect value added to a product or service. The tax base of a multistate taxpayer is apportioned to Michigan by application to the total tax base of the standard three-factor apportionment formula.

Trinova's challenge is based on the quicksand of rejected theories which equate financial gain or loss from multistate activities with capital and labor and which deny that market demand contributes to the creation of value added.

Trinova's SBT burden amounts to less than 29 cents for each $100 of its Michigan sales,

considerably less than the burden of the average single business taxpayer. Yet, its separate accounting argument concludes that it should pay zero tax for its privilege of doing business in Michigan.

Mr. Justice Frankfurter's remarks in Wisconsin v J C Penney Co, supra, are instructive:

> "For constitutional purposes the decisive issue turns on the operating incidence of a challenged tax. A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society." 311 US 444.

RELIEF SOUGHT

The judgment of the Supreme Court of Michigan should be affirmed.

Respectfully submitted,

FRANK J. KELLEY
Attorney General

Gay Secor Hardy
Solicitor General

Thomas L. Casey
Assistant Solicitor General
Counsel of Record
P. O. Box 30212
Lansing, MI 48909
(517) 373-1124

Richard R. Roesch
Assistant Attorney General
Attorneys for Respondent

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IN THE
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OCTOBER TERM, 1990

TRINOVA CORPORATION,
Petitioner,
v.
STATE OF MICHIGAN,
Respondent.

On Writ of Certiorari to the Supreme Court of Michigan

PETITIONER'S REPLY BRIEF

Of Counsel:
BENJAMIN O. SCHWENDENER, JR.
ALAN M. VALADE
SCHWENDENER & VALADE, P.C.
Dart Management Building
Mason, Michigan 48854
(517) 676-5137

WILLIAM F. SHEEHAN
COLLETTE C. GOODMAN
SHEA & GARDNER
1800 Massachusetts Ave., N.W.
Washington, D.C. 20036
(202) 828-2000

WALTER HELLERSTEIN
Professor of Law
University of Georgia
School of Law
Athens, Georgia 30602
(404) 542-5175

PETER S. SHELDON
(Counsel of Record)
THOMAS D. HAMMERSCHMIDT, JR.
JEFFERY V. STUCKEY
DICKINSON, WRIGHT, MOON,
VAN DUSEN & FREEMAN
215 S. Washington Square
Suite 200
Lansing, Michigan 48933-1812
(517) 371-1730

Counsel for Petitioner

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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Petitioner,

v.

STATE OF MICHIGAN,
Respondent.

On Writ of Certiorari to the Supreme Court of Michigan

PETITIONER'S REPLY BRIEF

INTRODUCTION

In our opening brief we urged that Michigan's use of the three-factor apportionment formula was theoretically unjustified as applied to the principal components (labor and capital) of its SBT tax base, which are site specific, and produced an unconstitutional result, mainly because of the inclusion of the sales factor in the apportionment formula. Respondent and its Amici devote most of their briefs to contesting the point that the value added by compensation and depreciation can be separately identified. Their principal argument on this score depends on characterizing the SBT as a tax on "unitary," "indivisible," "business activity," an argument that asks the Court to substitute labels for analysis and to disregard the language of the statute which carefully prescribes the components of what it is that Michigan is seeking to tax.

They also contend that the factors that contribute to *income*, and make it impossible to allocate a unitary business's income tax base—such as centralized management and purchasing, functional integration, and economies of scale—make it equally impossible to allocate a unitary business's production costs. But that argument, we shall demonstrate, is incorrect because it overlooks the fact that, even if such things as centralized management affect the total production costs incurred, they do not preclude precise identification of the amount of such costs or the place where they are incurred. We have conceded that these factors preclude precise identification of the place of one small piece—the business income—of Petitioner's (and everyone else's) tax base, so that this small piece can be constitutionally apportioned in some fair way. This leaves for decision the question whether this small tail may validly wag the much larger dog.

Respondent and Amici also seek to defend inclusion of the sales factor in the apportionment formula on the ground that value added does not exist until a sale occurs. We will show below, however, that when VAT is calculated by the additive method, whether the goods purchased are sold or remain in inventory, tax is levied as the value is added through the employment of labor or the use of capital.

Respondent and Amici also liken the SBT to other, valid taxes, proceeding on a theory of borrowed constitutionality, but this position also directs the Court away from the economic realities of the SBT.

We make these points in greater detail below. We also show that the Court's dismissal of *Armco Steel Corp. v. Department of Revenue*, 359 Mich. 430, 102 N.W.2d 522, *appeal dismissed*, 364 U.S. 337 (1960), should be irrelevant to the outcome here, and that neither Respondent nor Amici have rebutted our showing that the SBT is discriminatory.

I. THE COMPENSATION AND DEPRECIATION COMPONENTS OF THE SBT TAX BASE CAN BE IDENTIFIED AND ARE SITE-SPECIFIC

Respondent and Amici recognize that the justification for using an apportionment formula lies in the difficulty of delineating a tax base on a geographic basis. Hence they are at pains to characterize the SBT as taxing a base whose components cannot be separately identified. But their characterizations ask the Court to forego economic analysis, to ignore the language of the SBT as well as its practical effects, and instead to focus on various labels that once might have protected a state tax against constitutional challenge.[1]

A. Calling The SBT A Tax On Business Activity Cannot Save It

Both Respondent and Amici say repeatedly that the SBT is a tax on indivisible business activity, the components of which are "fused."[2] It follows, they say, that the components of the SBT tax base are as elusive to pinpoint geographically as the components of income under an income tax act. The supposed inability separately to identify, either by amount or location, the various elements of the tax base means that the tax base may be apportioned by the three-factor formula.

This argument draws conclusions from labels and looks past the economic facts that destroy it. The Act itself, while stating that it taxes "business activity," defines exactly what that term means by identifying precisely the individual components of the tax base. *See, e.g.*, §§ 3(3) and 9(1), Mich. Comp. Laws Ann. §§ 208.3(3)

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[1] The Court has rejected the approach in state tax cases "that focused primarily on the character of the privilege rather than the practical consequences of the tax." *American Trucking Ass'ns v. Scheiner*, 483 U.S. 266, 294-295 (1987).

[2] Resp. Br. 29; Amici Br. *passim* (the expression "business activity" appears 31 times in the first 15 pages of Amici's brief).

and 208.9(1), for the definition of "business income" (the profit component); §§ 4(3) and 9(5), Mich. Comp. Laws Ann. §§ 208.4(3) and 208.9(5), for the definition of compensation (the labor component); and § 9(4)(c), Mich. Comp. Laws Ann. § 208.9(4)(c), for the definition of depreciation (the principal part of the capital component). Indeed, the salient characteristic of an additive method VAT, which is what the SBT is (*see* Resp. Br. at 10-11), is that it identifies the components of the tax base—and even allows their separate taxation.[3] The legislature knew before the Act was passed that production costs—labor and capital—would dominate the tax base of "business activity,"[4] and in fact we now know that compensation accounts for 77% of the tax base for all taxpayers (and labor and capital together for something on the order of 94%).[5]

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[3] The ABA Special Committee on Value-Added Tax made the point in its Fifth Report:

> The additive-method VAT permits legislative flexibility if it is desirable or necessary to provide special tax treatment for the employment of labor. Special treatment also may be granted by applying one tax rate to "compensation" and another tax rate to the other factors of production—interest, rent, and profit. In effect, under the additive-method VAT, the legislature may tax compensation and profits differently.

Evaluation Of An Additive-Method Value-Added Tax For Use In The United States, Fifth Report of the Special Committee on Value-Added Tax, A.B.A. Sec. of Taxation, 30 Tax Lawyer 565, 580 (1977) (footnote omitted).

[4] *See* Haughey, *The Economic Logic Of The Single Business Tax*, 22 Wayne L. Rev. 1017, 1021 (1976).

[5] Pet. Br. 39; *see also*, Taxation and Economic Policy Office, Michigan Department of Treasury, *Analysis of the Michigan Single Business Tax* 27, Table 4 (1985). This Table is reproduced in our opening brief, Pet. Br., App. 1a. It is also an economic reality, to which Respondent has stipulated, that compensation accounted for 102% of Petitioner's tax base. Pet. App. 54a, Stipulated Facts, ¶ 8.

Contrary to Amici's contention (Amici Br. 11), there is nothing "imaginary" or "theoretical" about what we have just said. We have, rather, described "the practical effect of [the] challenged tax," *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 443 (1980), and the "economic realities" on which the Court must decide the SBT's constitutionality. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). Amici argue instead that the Court should disregard these practical realities and decide this case on the basis of their "theory" of the SBT—"that it is impossible to identify the 'value added' by isolated elements of a firm's business activity, a theory that makes formulary apportionment unavoidable." Amici Br. 13. But that supposed "theory" is at war with the economic facts. It is *not* impossible to identify the individual components of the tax base; on the contrary, the SBT identifies them *precisely* and, as the stipulated facts in this case show, the amount contributed to the tax base by each individual component can be calculated to the penny.[6]

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[6] Respondent ignores "economic realities" as well when, in the course of undertaking a rather superficial analysis, it observes that Petitioner had total gross receipts of approximately $391,000,000 during the tax year at issue and that Petitioner reported $221,000,000 (or 56.6%) of that amount as its total preapportioned tax base. Taking that data, Respondent then observes that since Petitioner realized gross receipts in Michigan of almost $104,000,000 in 1980, it therefore follows that $58,000,000 (56.6% of $104,000,000) reflects value added by Petitioner in Michigan. This leads to Respondent's absurd conclusion that Michigan "laid claim only to slightly more than one-third of this value added of $58,000,000 by apportioning $19,838,700—or approximately 33.71% of the value added contained in the products sold in Michigan." Resp. Br. 37-41. There is of course no logical basis, or record support, for concluding that the value added to its products by Petitioner is the same percentage of sales in every jurisdiction in which it does business or that sales bear any relevance whatsoever to the calculation of anything other than the typically modest profit component of an additive method VAT.

In short, whether the subject of the SBT is said to be "business activity," or "the privilege of doing business," [7] or "the complete range of entrepreneurial activities," [8] or even "value added," it is measured by—and thus it is a tax on—compensation, capital costs and, to a much lesser extent, profit.[9]

B. The Unitary Business Principle Adds Nothing To The Analysis

Respondent and Amici misplace their reliance on decisions of this Court upholding formulary apportionment of the income of unitary businesses.[10] The principal question in those cases was whether the income tax base of the taxpayer should include income from corporate affiliates (or operations) outside the taxing jurisdiction. That question does not arise here. There is no debate over the scope of Petitioner's business. The question that does arise is whether, whatever the tax base, the fact that Petitioner's business is unitary means that apportionment of its total SBT tax base is proper. The answer is no.

Respondent and Amici contend that the factors that contribute to income, and make it impossible to allocate a business's income tax base—such as centralized management and economies of scale—make it equally impos-

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[7] Resp. Br. 25.

[8] Amici Br. 11.

[9] "A tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes." *State Taxation of Interstate Commerce*, 27 Tenn. L. Rev. 239, 242 (1960).

[10] *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983); *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. New Mexico Dep't of Taxation and Revenue*, 458 U.S. 354 (1982); *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207 (1980); *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425 (1980).

sible to allocate a business's production costs. The argument is seductive in its simplicity but wrong.

Formulary apportionment in the context of taxing a unitary business under an income tax act is justified because it is not possible to pinpoint by geographical attribution the contributions to income resulting from centralized management, functional integration, and economies of scale—features typically found in unitary business enterprises. *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 438 (1980). These features do indeed impact on the level of profit or loss of a unitary business enterprise. This we have always conceded; and we have no quarrel with the three-factor apportionment formula as applied to the profit component of an SBT taxpayer's tax base. A company in the oil business may have producing wells in one state, exploratory wells in another, a refinery in another, and retail sales forces in still others. The difficulty of geographically allocating the company's overall income or profit on a state by state basis warrants resort to apportionment.

However, while it is also true that these same features may have some impact on the efficiency of the taxpayer's use of its labor force or its plant, it is nevertheless true (a) that the labor and capital components can be precisely identified by *amount* and by the *place* where they added value, and (b) that the *measure* of the value added by the labor and capital cost components is what the taxpayer pays for them.[11]

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[11] By parity of reasoning, the efficient use of real or immobile personal property of a multi-state manufacturer may also be affected by the market, yet that would not justify apportionment of an ad valorem tax on such property, whose location would remain the same regardless of the efficiency of its use. *See also, Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 617 (1981) ("the severance can occur in no other state" and "no other state can tax the severance," *quoting* 189 Mont. 191, 206, 615 P.2d 847, 855 (1980)).

For example, assume a "nonunitary business" and a "unitary business" engaged in competition with one another. Assume also, in connection with the production of a single unit, the following:

Identity of Item	Nonunitary Business	Unitary Business
Sale Price	$130.00	$130.00
Material Cost	30.00	28.00
Labor Cost	70.00	67.00
Capital Cost	20.00	19.00
Profit	$ 10.00	$ 16.00

Centralized management, functional integration, and economies of scale, we will assume, allow the unitary business to derive $6 more profit than the nonunitary business—attributable, in this example, to $2 less material cost, $3 less labor cost, and $1 less capital cost. These reduced costs are reflected in the profit component of a VAT tax base—the component that, concededly, may be subjected to three-factor formulary apportionment. However, the measure of the value added by the labor and capital components of both taxpayers is what the taxpayer paid for those items. With regard to the labor component, the measure of the value added remains $70 for the nonunitary business, $67 for the unitary business; and, for the capital component, the measure of the value added remains $20 for the nonunitary business and $19 for the unitary business.

Accordingly, Respondent and Amici are simply wrong to argue that just because Petitioner conducts a unitary business, the Due Process Clause allows apportionment of the total SBT tax base.[12]

[12] What is more, Respondent has publicly declared that the SBT does not incorporate the unitary method of calculation. *See*, Taxation and Economic Policy Office, Michigan Department of Treasury, *Analysis Of The Michigan Single Business Tax* (January, 1985), Appendix A at A8. So too have Michigan courts that have considered the question. *Wismer & Becker Contracting Engineers v. Mich. Dep't of Treasury*, 146 Mich. App. 690, 382 N.W.2d 505 (1985); and *W.R. Grace & Co. v. Mich. Dep't of Treasury*, 115 Mich. App. 69, 320 N.W.2d 62 (1982). Thus, Respondent is, at minimum, inconsistent in its application of the unitary business principle under the SBT.

In any event, even if it were so that any tax base of a unitary business was properly subject to some apportionment formula, that would not insulate the SBT from constitutional challenge since, as we have shown in our opening brief (Pet. Br. 32-37), application of the three-factor apportionment formula to Petitioner has produced a grossly distorted result. *Container Corp.*, 463 U.S. at 170. Moreover, as this Court has ruled:

> The only reason for allowing a state to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it, when they are part of an organic system of wide extent, that gives them a value above what they otherwise would possess. The purpose is not to expose the heel of the system to a mortal dart, —not, in other words, to open to taxation what is not within the state.

Wallace v. Hines, 253 U.S. 66, 69 (1920).

The compensation Petitioner paid to its Ohio employees "is not within the state" of Michigan and is not open to taxation there. If Michigan enacted a tax statute that forthrightly imposed a tax on a multistate business's compensation, no one would suppose that the Due Process Clause would permit that tax base to be apportioned according to the three-factor formula used to apportion income. Indeed, Respondent has conceded that this is so.[13]

[13] In the Michigan Supreme Court Respondent acknowledged that a tax on compensation "would apply to a tax subject so inherently locale-specific as to require specific allocation." *See* Pet. 12. In this Court Respondent also noted that labor and capital costs "are capable of geographic accounting, are locale specific." Opp. Pet. 13.

A different constitutional result cannot be obtained simply by reducing the compensation component of the tax base from 100% (under a direct tax on compensation) to 77% (the average for all taxpayers under the SBT)[14] and asserting that it is Petitioner's "business activity" that is being taxed.

In sum, the SBT is measured by the components of the value added tax base the Act itself identifies. The major components, compensation and depreciation, can be sourced to the states in which they are incurred. That economic fact cannot be gainsaid by describing the SBT as a tax on indivisible business activity, or by invoking the unitary business principle, or by suggesting a relationship between the market and the amount of those costs incurred.[15]

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[14] *Analysis Of The Michigan Single Business Tax, supra* note 5.

[15] Respondent mistakenly relies on language, taken out of context from *Amerada Hess Corp. v. Director, Division of Taxation*, 109 S. Ct. 1617 (1989), that the "costs of a unitary business cannot be deemed confined to the locality in which they are incurred" to support its claim that the labor and capital cost components of the SBT cannot be geographically segregated. Like the other cases on which Respondent relies, *Amerada Hess* concerned apportionment of *net income* and thus has no necessary bearing on the apportionment of site-specific labor and capital components of a value added tax base like the SBT. Furthermore, the Court's comments in *Amerada Hess* were directed to the question whether New Jersey could deny the nation's major integrated oil companies a deduction for federal Windfall Profit Taxes in computing such net income. Since the taxpayers were concededly conducting a unitary business from well-head to gas pump, *id.* at 1621, their income was apportionable by New Jersey in any event, and the only issue was whether a particular cost of earning admittedly apportionable income had to be allowed as a deduction because the cost was allegedly incurred outside the state. Finding it "unnecessary" even to reach the critical question that divides the parties here, namely, whether particular elements of the tax base are "site-specific," *id.* at 1622 & 1622 n.7, the Court found that the costs of generating unitary income are *by definition* no less unitary than the income itself, *id.*, because "the resulting net figure is still a unitary one." *Id.* Thus, while *Amerada Hess* may indeed support apportionment of costs as well as revenues of a unitary busines in calculating an income tax base, the decision has little relevance to the question whether compensation and depreciation, the site-specific cost components of a value added tax base, can be geographically determined.

II. VALUE IS ADDED BEFORE SALES OCCUR

In further support of their "indivisibility" argument, and in defense of the SBT's inclusion of the sales factor in its apportionment formula, Respondent and Amici argue that there is no value added by the labor of a taxpayer's employees or by the consumption of its capital resources until a sale occurs. Resp. Br. 47-50; Amici Br. 15-20. There is no explanation of why that is so, and in fact it is not.

Under a VAT using the additive method, like the SBT, the value added by the labor component is *realized* when the taxpayer incurs the cost for the labor of its employees. The value added by the capital component is realized when the capital is consumed. As the ABA's Special Committee on Value-Added Tax observed: "When VAT is calculated by the additive method, whether the goods produced are sold or remain in inventory, tax is levied as the value is added. . . . In essence, the additive method accelerates tax liability. Prior to sale, a firm adds value through the employment of labor or the expenditure of funds for rent and interest. . . . [T]he profit component of the VAT base generally arises by virtue of the sale of goods or the rendition of services."[16]

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[16] *Evaluation Of An Additive-Method Value-Added Tax For Use In The United States*, Fifth Report of the Special Committee on Value-Added Tax, A.B.A. Sec. on Taxation, 30 Tax Lawyer 565, 568 & n.15.

If sales occur in a later tax period than labor payments and capital consumption, the timing of tax reporting will be different under the addition and subtraction methods. The addition method will realize and recognize value added when labor is paid and capital

A concrete example may be useful. Assume that, in the manufacture of its product, a taxpayer purchases raw materials for $3, incurs labor and capital costs of $12 and $2, respectively, and sells at $18, for a $1 profit. If during the tax year 100 units are manufactured but 50 sold, the tax base of an additive type VAT will consist of $50 profit, $1200 compensation, and $200 capital—even though $600 of the compensation and $100 of the capital costs are attributable to goods that sit on the inventory shelf.

Nor are sales required in order to determine the *amount* of the value added by the labor and capital components of a value added tax. The measure of the value added by labor and capital, determined again at the point of realization, is the taxpayer's cost—what it paid in compensation for the services of its employees; what it paid in interest for use of borrowed capital; what it consumed of its plant in the form of depreciation.

Evidence that this is so may be found in the SBT itself. Thus, SBT § 9, Mich. Comp. Laws Ann. § 208.9 (West 1990), specifically describes the labor and capital components of value added in terms of what the taxpayer pays for those items. Sales impact only on the measure of the profit component of value added.

The Michigan Supreme Court has also observed that the measure of value added for labor and capital is what the taxpayer pays for same. That Court has noted:

> The value of the inputs used is measured by the cost to the producer of obtaining the use of those inputs. The value of the worker's labor is the wages the laborer is paid to produce the good. The value of the . . . capital is what the producer must pay . . . [for

consumed, whereas the subtraction method will defer recognition of those items for tax reporting purposes until the period in which the sale occurs.

> its] use . . . . And the profit is what keeps the producer-entrepreneur in business, which is measured by the difference between the cost of production and the receipts from sales.

Mobil Oil Corp. v. Mich. Dep't of Treasury, 422 Mich. 473, 493-494, 373 N.W.2d 730 (1985).

In sum, sales are required neither to *realize* value added by the labor and capital components of tax base nor to determine the measure or *amount* of the value added by the labor and capital cost components.

III. THE SBT CANNOT BORROW CONSTITUTIONALITY FROM OTHER TAXES

Respondent and Amici claim that in practical effect the SBT is like an income tax, or a sales tax, or a gross receipts tax, or halfway between a gross receipts tax and an income tax, or a "derivative" of a gross receipts tax. *E.g.*, Resp. Br. 15-16; Amici Br. 23. These comparisons are all meant to put the SBT in good company, but they cannot establish its innocence by association.

Respondent's placement of the SBT halfway between an income tax and a gross receipts tax leads to its argument that, since those taxes may be apportioned through some fair formulary method, the SBT should be as well. Resp. Br. 15-17. So far as we are aware, however, no gross receipts tax has ever been apportioned by the three-factor formula.[17] The same is true of sales taxes, to which Amici also compare the SBT. Amici Br. 23. The comparison to an income tax is equally unhelpful: income makes up 100% of the tax base of an income tax,

[17] The State of Washington is the only state with a broad based, business gross receipts tax. As to a business operating within and without the state, the tax requires actual allocation of receipts and, if that is infeasible, apportionment based on in-state versus out-of-state costs of production. *Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue*, 483 U.S. 232 (1987).

whereas it makes up about 6% of the SBT tax base. It is wholly appropriate to apportion the income component of the tax base, for the same reason that the three-factor formula has been accepted in many income tax cases, but Michigan may not constitutionally allocate to itself the bulk of the tax base that is identifiably located elsewhere simply because it is appropriate to apportion the little piece of the tax base that cannot accurately be identified with any particular location.[18]

Amici say that we champion a "wooden semanticism" because we have allegedly conceded that the SBT "would be immune from constitutional attack were it labeled a tax on gross receipts." Amici Br. 22, 25. We conceded no such thing. We said that Michigan could have imposed a *different tax*—a gross receipts tax—on Petitioner that would have yielded as much or more tax revenue as did the SBT. Pet. Br. 35-36. Amici challenge us for "asserting that the SBT cannot be validated by the availability of some alternative constitutional tax" (Amici Br. 23), but our assertion must be right. It cannot be the law that the test of one statute's constitutionality is whether it produces no more tax revenue than some other statute whose validity is unchallenged. *McLeod v. J. E. Dilworth Co.*, 322 U.S. 327, 330 (1944).

Amici's suggestion that *McLeod* is no longer good law is altogether wrong. It is still the law that an unconstitutional tax cannot be defended by showing that a different or even similar tax—one measured by a different tax base or imposed upon different taxpayers—could have been adopted, constitutionally, by the state. Many considerations enter into what kind of tax a state chooses to adopt. Aggregate tax collections may be different; taxpayers may pay different amounts. The validity of

[18] The comparison to an income tax is also inapt because, if Michigan had adopted an income tax, Petitioner would have paid no taxes at all since it incurred a loss for the year here at issue. *See*, Pet. Br. 14.

the tax a state has chosen to adopt must be determined by what the state has done and not by what it might have done.

IV. THE DISMISSAL IN ARMCO IS NOT CONTROLLING

Respondent and its Amici purport to find support for the constitutionality of the SBT in this Court's order, thirty years ago, summarily dismissing a challenge to Michigan's former Business Activities Tax (BAT), which allegedly resembled the SBT "in all essential details." Resp. Br. 12-14; Amici Br. 21; *Armco Steel Corp. v. Department of Revenue*, 359 Mich. 430, 102 N.W.2d 522 (1960), *appeal dismissed*, 364 U.S. 337 (1960). Wholly apart from the little deference the Court gives to summary dispositions, *Ashland Oil, Inc. v. Rose*, —— U.S. ——, ——n * (Slip Op. at 4 n.*) (1990) (Per Curiam); *Caban v. Mohammed*, 441 U.S. 380, 390 n.9 (1979), examination of the questions raised in *Armco* demonstrates rather clearly that the decision in *Armco* has no bearing on the issues raised by Petitioner here.

The principal question that the appellant sought to raise in *Armco* was whether Michigan's BAT, which was measured by gross receipts less specified deductions and was apportioned by the standard three-factor income tax apportionment formula, should be characterized as an income tax or as a gross receipts tax. This Court had recently determined that a fairly apportioned net income tax could be imposed on a multistate business without constitutional objection, *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), but it was still thought that a gross receipts tax on interstate commerce constituted a "direct" burden on interstate activity that violated the Commerce Clause. *Freeman v. Hewit*, 329 U.S. 249 (1946).[19] The Michigan Supreme

[19] It was not until 1977 in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), that the Court rejected the rule of *Freeman* that "a direct tax on interstate sales, even if fairly apportioned

Court, emphasizing throughout its opinion that the BAT is "not a gross receipts tax" (359 Mich. at 444, 102 N.W.2d at 560) "but an income tax" (359 Mich. at 449, 102 N.W.2d at 562),[20] found *Northwestern* "definitely controlling," 359 Mich. at 453, 102 N.W.2d at 564, and sustained the levy.

On appeal to this Court, the parties continued their debate over whether the BAT was a presumably constitutional tax on income from interstate commerce or a presumably unconstitutional tax on gross receipts from interstate commerce. Thus, the appellant characterized the BAT as a "direct" tax on gross receipts, arguing that a "state tax on gross receipts from interstate commerce is indistinguishable from a direct tax on that commerce." Jurisdictional Statement in *Armco*, at 14. The State responded that the BAT was an "income tax" and therefore "not a forbidden direct tax on interstate commerce." Motion to Dismiss or Affirm at 12. If one can reliably conclude anything from the Court's summary dismissal of the appeal, it is that the Court accepted the Michigan court's description of the BAT as a fairly apportioned income tax, which was clearly constitutional under *Northwestern*. It surely does not mean that the Court determined that a constitutional issue not even raised or discussed by the parties was unworthy of full consideration.

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and nondiscriminatory, was . . . unconstitutional per se." *Id.* at 280.

[20] The Michigan court observed that the title of the act adopting the BAT "announces it to be 'An act to provide for the raising of additional public revenue by prescribing certain *specific taxes on income* * * *.'" 359 Mich. at 443, 102 N.W.2d at 559 (emphasis in original); that cases like *Freeman* involved "direct taxes on gross receipts from interstate commerce" that "are forbidden to the States" and not "as here, an apportioned adjusted receipts or income tax," 359 Mich. at 447, 102 N.W.2d at 561; and that the tax "is arrived at by imposing a rate and applying an apportionment formula to 'adjusted receipts' or 'income.'" 359 Mich. at 452, 102 N.W.2d at 564.

In the present case, by contrast, the critical question is not whether the SBT fits into the pigeonhole of an "indirect" income tax or a "direct" gross receipts tax on interstate commerce. *Complete Auto Transit* teaches that such labels are no longer controlling, and, in any event, Respondent concedes that "the SBT cannot be construed as a net income tax." Resp. Br. 15. Rather, the question is whether a tax—however denominated—that falls largely on labor and capital costs can pass constitutional muster when the lion's share of those costs are incurred outside the taxing state. There is nothing in the formal debate that dominated the *Armco* case to suggest that the Court ever gave this issue any thought, and it is therefore unreasonable to contend that the Court's dismissal of the appeal in *Armco* has any bearing here.

V. THE SBT DISCRIMINATES AGAINST OUT-OF-STATE TAXPAYERS

Neither Respondent nor Amici answer Petitioner's underlying claim of discrimination except to state that which is both true and irrelevant: a state may encourage economic activity. While that may be a valid objective for a state in structuring a tax, it may not do so in a discriminatory manner. Thus, this Court observed in *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 278 (1988), that:

> The Commerce Clause does not prohibit all state action designed to give its residents an advantage in the marketplace, but only action of that description *in connection with the State's regulation of interstate commerce.* Direct subsidization of domestic industry does not ordinarily run afoul of that prohibition; discriminatory taxation of out-of-state manufactures does. (Emphasis in original).

Most of what is offered to substantiate Respondent's claim that the SBT does not discriminate against Petitioner or other out-of-state taxpayers is really no response at all. For instance, it is declared that evidence

of nondiscrimination is found in the three-factor formula itself. The fact that it does not contain a doubleweighted sales formula or that it does not delete one of the property, payroll, or sales factors from the formula is, as Respondent sees it, evidence of nondiscrimination. This response, of course, merely begs the ultimate question. As another example, Amici attempt to steer a course through those decisions that have addressed discriminatory state taxes—trying to distinguish the case presented here from those cases because the alleged discrimination here does not involve facially different tax rates, credits or exemptions. Amici's attempt on that score fails also, however, since the "practical operation" of the SBT discriminates against interstate commerce and that alone is all that need be demonstrated. *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 69 (1963).

Respondent attempts also to discredit Petitioner's example of discrimination (Pet. Br. 39-41) by claiming that it should not escape attention that the hypothetical Michigan business is also subject to Ohio's income tax. Resp. Br. 66-69. Respondent then proceeds to put together a rather complicated hypothetical scenario designed to demonstrate that the Michigan business will pay more tax to Michigan and Ohio than will the Ohio business. Of course, there is no record support for this proposition; and, even if there were, Respondent's example would not cure the discriminatory effect of the SBT. The discriminatory effect of the SBT is not ameliorated by demonstrating that the Michigan business pays more to both states in the aggregate than does the Ohio business.[21] If it is true, as we contend, that the SBT systematically reduces the tax bases of businesses located principally within the state that sell their products elsewhere, while systematically

[21] This is really no more than the reverse of the argument made by the taxpayer and rejected by the Court in *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 277 n.12 (1978). *See also, Armco, Inc. v. Hardesty*, 467 U.S. 638, 644, 645 (1984).

increasing the tax bases of businesses located principally outside the state that sell their products in Michigan, it is irrelevant how the Michigan taxpayers may fare under tax statutes of other states.

CONCLUSION

The judgment of the Supreme Court of Michigan should be reversed.

Respectfully submitted,

Of Counsel:
BENJAMIN O. SCHWENDENER, JR.
ALAN M. VALADE
SCHWENDENER & VALADE, P.C.
Dart Management Building
Mason, Michigan 48854
(517) 676-5137

WILLIAM F. SHEEHAN
COLLETTE C. GOODMAN
SHEA & GARDNER
1800 Massachusetts Ave., N.W.
Washington, D.C. 20036
(202) 828-2000

WALTER HELLERSTEIN
Professor of Law
University of Georgia
School of Law
Athens, Georgia 30602
(404) 542-5175

PETER S. SHELDON
(Counsel of Record)
THOMAS D. HAMMERSCHMIDT, JR.
JEFFERY V. STUCKEY
DICKINSON, WRIGHT, MOON,
VAN DUSEN & FREEMAN
215 S. Washington Square
Suite 200
Lansing, Michigan 48933-1812
(517) 371-1730

Counsel for Petitioner

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In The

Supreme Court of the United States

October Term, 1989

TRINOVA CORPORATION,

Petitioner,

v.

STATE OF MICHIGAN,

Respondent.

On Writ Of Certiorari To
The Supreme Court Of Michigan

BRIEF OF CATERPILLAR INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONER

DON S. HARNACK
(Counsel of Record)
RICHARD A. HANSON
GREGORY G. PALMER
CAROL S. PORTMAN
McDERMOTT, WILL & EMERY
111 West Monroe Street
Chicago, Illinois 60603
312/372-2000
Attorneys for Caterpillar Inc.

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OR CALL COLLECT (402) 342-2831

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BRIEF OF CATERPILLAR INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF CATERPILLAR INC.

Caterpillar Inc. ("Caterpillar"), with the consent of the parties, submits this brief as *amicus curiae* in support of Trinova Corporation. Caterpillar, a Delaware corporation headquartered in Illinois, is the plaintiff in *Caterpillar Inc. v. State of Michigan, Department of Treasury*, Nos. 84-9664-CM and 87-11109-CM (consol.) (Michigan Court of Claims). Caterpillar has raised the same constitutional

objections and has requested apportionment relief substantially identical to that requested by Trinova Corporation. The decision in this case will directly affect Caterpillar's Michigan litigation.

SUMMARY OF ARGUMENT

The constitutionality of the Michigan Single Business Tax ("SBT") must be determined by analyzing its practical economic effect. In practical economic effect the SBT is a tax on labor.

The formula used to apportion a state tax must be rationally related to that type of tax. The three factor formula is not a rational means of apportioning the SBT tax base.

ECONOMIC AND LEGAL ANALYSES OF THE SBT

Mr. Robert J. Kleine was the Director and Dr. James Haughey the Assistant Director of the Office of Revenue and Tax Analysis, Michigan Department of Management and Budget, during the period in which the SBT was proposed, debated and enacted. They are acknowledged to be the primary architects of the SBT.

Mr. Kleine reviewed the design and operation of the SBT in *The Michigan Single Business Tax: A Different Approach to State Business Taxation*, Advisory Commission on Intergovernmental Relations (1978) (hereinafter cited as "ACIR"). Dr. Haughey prepared the working paper

which served as the starting point for legislative consideration of the SBT.[1] He also wrote "The Economic Logic of the Single Business Tax," 22 Wayne Law Review 1017 (1976).

Professor Oliver Oldman is the Learned Hand Professor of Law at Harvard Law School. Professor Oldman is one of the nation's leading experts on value added taxation. His qualifications include consultation with foreign governments regarding value added taxation and service on American Bar Association and United States Department of Treasury committees involving value added tax questions. In 1987, Professor Oldman testified as an expert witness regarding value added taxation and the SBT in *Caterpillar Inc. v. Department of Treasury*.[2] His testimony was directed primarily to the nature of a value added tax and the proper method of determining the Michigan value added of multistate taxpayers.

Caterpillar has taken the liberty of quoting extensively from the works of Dr. Haughey and Mr. Kleine and the testimony of Professor Oldman. They explain in clear and cogent terms the practical economic effect of the SBT and the fundamental flaw in the SBT's apportionment method.

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[1] This paper, *A Proposal for a Michigan Value Added Tax*, is reproduced as Appendix A.

[2] Professor Oldman's resume and his testimony is reproduced as Appendix B.

ARGUMENT

I. THE PRACTICAL ECONOMIC EFFECT OF THE SBT

The SBT is a novel form of state tax. Nonetheless, in determining whether it satisfies Commerce Clause concerns the approach is the same as for any other state tax: the SBT must be tested against its practical economic effect on interstate business.

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, *reh'g denied*, 430 U.S. 976 (1977) this Court held that Commerce Clause questions are to be answered by considering "not the formal language of the tax statute but rather its practical effect . . . " 430 U.S. at 279. In adopting this standard, the Court explicitly rejected a test based on the nature of the privilege being taxed, stating:

> There is no economic consequence that follows necessarily from the use of the particular words, 'privilege of doing business,' and a focus on that formalism merely obscures the question whether the tax produces a forbidden effect.

430 U.S. at 288.

In *American Trucking Associations, Inc. v. Scheiner*, 483 U.S. 266 (1987), this Court reiterated:

> In our more recent decisions we have rejected this somewhat metaphysical approach to the Commerce Clause that focused primarily on the character of the privilege rather than the practical consequences of the tax. In 1977, while we recognized that we had invalidated privilege taxes on in-state activity deemed to be part of interstate commerce, we also noted that we had 'moved toward a standard of permissibility of

> state taxation based upon its actual effect rather than its legal terminology.'

483 U.S. at 294-295. The Court further explained:

> The way in which a tax levied on participants in interstate commerce is measured and assessed bears directly on whether it implicates central commerce clause values.

483 U.S. at 282.

The "actual effect" of the SBT, the way it is "measured and assessed" on interstate business determines whether the tax is constitutional. In actual effect the SBT is primarily a tax on the use of labor. In design and in actual operation it is measured by and assessed on compensation paid.

A. The Economic Design of the SBT

In 1975, the State of Michigan responded to a fiscal crisis by adopting the SBT. As Dr. Haughey and Mr. Kleine describe the situation, Michigan's existing business taxes had two major flaws. First, the primary business taxes – the corporate income tax, franchise tax and personal property tax – fell disproportionately on profits and capital. As a result, Michigan had developed a reputation as a state with a poor climate for business investment. Second, business tax revenues were unstable and cyclical. The tax base needed to be broadened to provide more predictable revenues to fund state services. Appendix A at A-4, A-26; ACIR at 21.

A tax system based on the value added concept was proposed to solve these problems. It was anticipated that

a value added tax would improve the attractiveness of Michigan as a place for investment by equalizing the tax burden between capital and labor. As described by Dr. Haughey:

> [T]he switch to the SBT was intended to reduce the heavy burden of taxation on capital in Michigan. All of the taxes repealed were strictly on capital while the SBT taxes capital and labor costs equally. The expected result, after an adjustment process, is the stimulation of job-creating capital investments in Michigan and expansion of demand for the goods and services of local market industries.

22 Wayne L. Rev. at 1021-22.

The goal of revenue stability would also be accomplished. Again quoting Dr. Haughey:

> [T]he switch to the SBT was intended to increase the stability of state business tax revenues over the business cycle. This was to be accomplished by abandoning profits as the principal business tax base and adopting value added, the sum of labor and capital costs, which is inherently more stable than the narrow margin between sales and expenses.

22 Wayne L. Rev. at 1021 (footnote omitted). Kleine concurs. He states:

> The instability of the business tax structure, particularly the corporate income tax, had precipitated two budget crises in Michigan, in FY 1970-71 and 1974-75. Therefore the proponents of the VAT believed the corporate income tax to be an inappropriate tax for a state with such a volatile economy. The VAT is much more stable than the corporate income tax, largely because

> 75% of the base consists of compensation, which is not subject to wide swings from year to year.

ACIR at 21.

A final benefit of the SBT was a closer matching of tax burdens with the benefits each business received from governmental services. Because the amount of Michigan governmental services consumed, e.g., roads, utilities, fire and police protection, education and social welfare services, is related to the economic size of the business (amount of labor and capital used in the form of the company's work force and its production and distribution facilities in Michigan) and because the value added tax base also reflects the taxpayer's economic size in Michigan, a value added tax would impose tax burdens more nearly proportional to the governmental services used by each business. See, e.g., ACIR at 23. The base broadening thus accomplished three goals: reducing the burden on capital, improving revenue stability and making the tax more proportional to benefits received.

B. The SBT is Primarily a Tax on Labor

The components of a value added tax base are well recognized. The Michigan Supreme Court described these components in *Mobil Oil Corp. v. Department of Treasury*, 422 Mich. 473, 373 N.W.2d 730, *reh'g denied*, 422 Mich. 1264 (1985):

> The value of the inputs used is measured by the cost to the producer of obtaining the use of those inputs. The value of the worker's labor is the wages the laborer is paid to produce the good. The value of the raw materials, intermediate goods, and capital is what the producer must

> pay in order to obtain the use of these things. And the profit is what keeps the producer-entrepreneur in business, which is measured by the difference between the cost of production and the receipts from sales.

422 Mich. at 493-94, 373 N.W.2d at 740.

Professor Oldman elaborated on the notion that the SBT tax base consists of discrete identifiable components:

> And in the report of the Special Committee on VAT, which had a number of reports, 1971 to 1977, I quote from the definition that was in there, "the tax base on which a VAT is levied is essentially equivalent to the sum of a firm's profits and payments for its factors of production not subject to VAT – normally interest, compensation, depreciation and rentals paid." That is, the input on which somebody else has paid VAT is not part of the taxpaying firm's VAT. And its profits and payments include normally, and I quote again, "interest, compensation, depreciation and rentals paid."
>
> So these definitions of value added are widely accepted and understood, both by the policymakers, the theoreticians, and the legislators, and the courts, which have said something about it.

Appendix B at B-21 – B-22.

By far the largest of the value added components of the SBT is labor.[3] Sidney Goodman, former Michigan

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[3] Labor makes up approximately 77 percent of the SBT base. Profit makes up less than 6 percent and the remainder consists of other items, primarily depreciation. "Analysis of the Michigan Single Business Tax," Taxation and Economic Policy

(Continued on following page)

Commissioner of Revenue, acknowledged the importance of the labor component in his paper delivered at the NTA-TIA Annual Conference on November 16, 1976, "Administrative Aspects of the Michigan Single Business Tax (VAT)," which is reproduced in Kleine's monograph:

> From studies made we have found that compensation has in many instances exceeded 70% of the tax base. The only relief granted in the law is a circuit breaker provision limiting compensation to 65% of the tax base so that high-labor-intensive firms would have some relief. The issue at the present time is whether this limit should be lowered in order to prevent the single business tax from being a tax on labor.

ACIR at 55. Mr. Kleine echoes these observations:

> As more than three-quarters of value added reflects labor input, the VAT looks to be largely a tax on labor.

ACIR at 23. Professor Oldman further confirmed this point in the following colloquy with Department of Treasury counsel:

> A. A tax on value added is a tax on payroll to a very important extent.
>
> Q. This is where we disagree. A tax on value added is a tax upon the incremental mark-up at any stage of production.
>
> A. And that's largely constituted by payroll. The markup is, in your example, where there is an 80 percent payroll, 80 percent of

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(Continued from previous page)

Office, Michigan Department of Treasury, Table 4, p.27. (January, 1985)

the markup is due to payroll, to compensation.

Q. That is when you look at the – that is purely a sourcing theory?

A. It's a fact, it's a fact. You don't need a label legal or otherwise on it. 80 percent of the difference between sales and taxable input is compensation. And that's what the books show. And that is the heart of value added.

Appendix B at B-64 – B-65. These comments by Goodman, Kleine and Professor Oldman explain why the title of Dr. Haughey's draft statute was "PROFITS AND PAYROLL TAX ACT OF 1975." Appendix A at A-8.

II. THE USE OF THE THREE FACTOR FORMULA IS NEITHER RATIONAL NOR CONSTITUTIONAL

Michigan's decision to use the three factor formula to apportion the tax base of interstate businesses was not founded on logic or analysis. The drafters believed that use of the formula was compelled by Michigan's membership in the Multistate Tax Compact. As Mr. Haughey put it:

> A final practical concern is the treatment of multistate taxpayers. The former BAT and the current corporation income and corporation franchise tax employ the three factor Massachusetts formula to apportion income between states. Michigan's membership in the Multistate Tax Compact will undoubtedly require the same formula for the VAT. The current proposal reluctantly assumes the use of the three factor formula.

Appendix A at A-8. Whether required by the Compact or not, the three factor formula is not constitutional when used in the SBT because it is not rationally related to the determination of value added in Michigan.

In *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S. 317, *reh'g denied*, 390 U.S. 1046 (1968), the taxpayer challenged the formula used by Missouri to determine its Missouri property. The Court stated:

> Any formula used must bear a rational relationship, both on its face and in its application, to *property* values connected with the taxing State.

390 U.S. at 325. [Emphasis added]

In *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983), the taxpayer challenged the formula used by California to determine its California income. The Court again stated:

> The second and more difficult requirement is what might be called external consistency – the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how *income* is generated.

463 U.S. at 169. [Emphasis added]

Here the taxpayer has challenged the formula used by Michigan to determine its Michigan value added. The formula used by Michigan must be rationally related to and reflect a reasonable sense of how Michigan *value added* – primarily labor usage – is generated. The three factor formula fails this test.

A. The Three Factor Formula Does Not Properly Identify Michigan Value Added Activities

Professor Oldman and Mr. Kleine agree that the three factor formula, and particularly the sales factor, is not rationally related to the activities which generate Michigan value added. As Mr. Kleine states:

> The standard three factor formula [payroll, property, sales] was used to apportion the tax base of multistate taxpayers. Value added theory would dictate that the tax be calculated on an "origin" basis and implies use of the two-factor formula – property and payroll.

ACIR at 7. He goes on to point out that:

> A tax on value added is levied at the source of production, at the origin, whether that production is intended for sale in another state or country.

ACIR at 14, note 5.

In response to a question concerning the relevance of sales to a value added tax, Professor Oldman answered:

> A. Well, sales represent, you might say, the consummation of the entire value-adding process. The sales price of goods represents the total value added by the firms that sell those goods, plus the value added by all the firms which supplied input to the taxable firm that we are now taxing. So the sales of the firm include not only its value added, but also the value added by the firm's suppliers. If what you are trying to identify is the location of the firm's value added, then sales – the location of sales would basically be irrelevant. It's the components of value added that you are trying to locate, not the

> sales. The sales are the sum total, the result of the value adding process. But the sales don't tell you where the value was added. Therefore, it's an extraneous factor to determining the geographical location of the value added. The components are the profit and the wages. They are the primary components. The wages can be located easily by knowing where the work was done. So one doesn't need a formula at all for that.

Appendix B at B-29 – B-30. Professor Oldman goes on:

> Q. As I understand your testimony, then, it would be your opinion that the sales factor is not appropriate for utilization in the value-added tax?
>
> A. Right, it is my opinion that the sales factor, that sales themselves, represent the ultimate goal of the value adding process, and that to use that to geographically locate where the value was added provides a misleading geographic picture of where the value-adding process takes place.
>
> When a jurisdiction purports only to tax value added within its jurisdiction, that originates within its state or country, and it has taxpayers who operate in more than one jurisdiction, it has to face up to the problem of geographical division of the tax base. The way to do that is not by looking at where the sales take place, you use sales to apportion gross receipts taxes, and you use sales in conventional corporate income tax as a handy representation of the demand factor in producing profit. But to use sales in the value-added tax is almost a contradiction in terms, because it's not really related to the value added tax process.

Appendix B at B-33 – B-34.

Use of the three factor formula in the SBT does not satisfy the "external consistency" test articulated in *Container* and *Norfolk & Western*. It is not rationally related to the value added process and in Professor Oldman's phrase "provides a misleading geographic picture of where the value-adding process takes place".[4] The Commerce Clause does not permit use of such a formula.

B. The Valued Added Attributable To Labor Usage Can Be Geographically Identified

In his testimony, Professor Oldman repeatedly made a simple point – no formula is required to determine Michigan's share of an interstate company's labor usage. As Professor Oldman put it:

> In the world of value-added tax, you know where most of the value added is, in fact, added because you know where the workers are. So you don't have to use the formula. You take the wages paid for services performed at a location and say that's the value added by compensation in that area.

[4] There will undoubtedly be cases where the three factor formula produces a reasonable approximation of the taxpayer's Michigan value added. This would happen, for example, when the percentage of the taxpayer's Michigan property, payroll and sales are roughly equivalent. Even in that case, however, the formula approximates reality by accident, not design. Appendix B at B-63. It is equally certain that there will be cases where the formula understates Michigan value added. This will occur when the formula is used by Michigan based companies which ship most of their production to consumers in other states. Appendix B at B-75.

Appendix B at B-29. Professor Oldman made the same point when discussing Michigan court decisions which permitted taxpayers to determine their compensation on a geographical basis. He stated:

> If the Department of the Treasury applies the statute in a way in which an artificial result is achieved as it was proposed in the *J&L*, then the courts come in and bring reality into the picture, and state, quite correctly, that you can't locate where the payroll element or components of value added are by looking at where the sales took place, or where the sales ended up. You locate payroll by looking at where the people worked.

Appendix B at B-32.

In the end, this is all that Trinova has asked the Michigan courts to do – bring reality into the picture and locate Trinova's payroll by looking at where its people work. Trinova has established its total payroll in Michigan. This is all the labor cost Michigan may tax.

CONCLUSION

The SBT should be recognized for what it is – a tax on labor. The three factor formula is not designed to and does not in practice fairly apportion the tax base of Trinova and similar companies. The decision of the Michigan Supreme Court should be reversed with instructions to grant Trinova the right to pay tax on its actual Michigan value added.

Respectfully submitted,

DON S. HARNACK
(Counsel of Record)
RICHARD A. HANSON
GREGORY G. PALMER
CAROL S. PORTMAN
McDERMOTT, WILL & EMERY
111 West Monroe Street
Chicago, Illinois 60603
(312) 372-2000
Attorneys for Caterpillar Inc.

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APPENDIX A

A PROPOSAL FOR A MICHIGAN VALUE ADDED TAX

James Haughey
Department of Management
and Budget
State of Michigan
Lansing, Michigan
December 27, 1974

PREFACE

This paper contains a rough outline of a Value Added Tax (VAT) now being considered by the State of Michigan. No decision has yet been made to seek the adoption of VAT and other tax alternatives, in lieu of a VAT, are being considered.

The paper briefly states the reasons for considering a VAT, outlines tentative draft legislation and discusses the principal theoretical and practical decisions that need to be made. As the paper was prepared under a strict time constraint it raises many questions that are left unanswered and may ignore some important considerations.

The purpose of the paper is to elicit comments and criticism from interested and knowledgeable people. Comments are welcome on the theoretical design of the tax, the language of the enabling legislation, practical problems in administration and compliance, the economic effects of a shift to a VAT, the financial impact on various industries, unique problems in certain industries and methods for forecasting the receipts from a VAT.

Introduction

The State of Michigan is considering the adoption of a Value Added Tax (VAT). Present, tentative plans are for enabling legislation to be introduced in the spring of 1975, with the effective date set for January 1, 1976.

From 1953 to 1967 Michigan had a Business Activities Tax (BAT) similar in many ways to a VAT. The BAT was originally enacted in lieu of a corporation income tax and was ultimately replaced by that tax. The BAT was essentially a gross receipts tax that permitted more exemptions and deductions than would be allowed by a pure VAT.

Two years ago a VAT was proposed as part of the financing mechanism for a constitutional amendment requiring state financing of local schools. The amendment was defeated and the VAT dropped from public view. As the defeated constitutional amendment was quite controversial and complex the public reaction to the VAT proposal was not at all clear. However, it was generally supported by business groups and opposed by labor groups.

The purpose of this paper is to present an outline of the nature and use of the VAT proposed in Michigan. This paper is intended to serve as a point of departure. It raises what are thought to be all of the relevant questions that must be answered concerning the theoritical design of a VAT, the practical application of the concept and the economic impact of a shift from other taxes to a VAT. Many of these questions are answered here. The answers reflect current thinking and do not reflect final decisions. The VAT could be a replacement for the corporation income tax, the corporation franchise tax, the business

portion of the intangibles tax, the financial institutions income tax, the personal property tax on inventory, and possibly the insurance premiums tax. A small amount of additional revenue would also be raised by the VAT.

Overview of Proposal

The VAT being proposed here can be described as a consumption type VAT with the tax base determined by the addition of factor payments made by the taxpayer. The tax is to be collected like an income tax with quarterly estimates and an annual settlement.

Three types of VAT bases are possible:

1) The gross product base with no deduction for either capital consumption or capital acquisition.

2) The "income" variant with deductions permitted for capital consumption.

3) The "consumption" variant with deductions permitted for capital acquisition.

The gross product base is rejected because some type of capital deduction is too well accepted to be challenged and because capital expansion ought not to be penalized.

Allowing depreciation and depletion was rejected because much of the uncontrollable, unpredictable and arbitrary features of the corporation income tax are in the depreciation/depletion section of the law. One of reasons for considering a shift to the VAT from the income tax is to make business taxes more stable, more predictable, and more controllable by the state. The profits tax base is, to a large extent, beyond the control of the state. Congress and the IRS can and do alter the state profits tax

base for their own purposes and without adequate warning or explanation. Changes in depreciation/depression [sic] rules are announced frequently. A fuller discussion of the superiority of the VAT over those taxes it would replace follows later.

The deduction of capital acquisition costs was selected on its merits and not because of the faults of the other two options. In the past few years numerous efforts have been made in Michigan, some successfully, to enact "tax incentives" for business expansion. The tax laws now contain a variety of such incentives, generally discriminatory and inefficient. A capital acquisition deduction in the VAT, together with a necessarily higher tax rate, could serve as a once and for all super tax incentive in lieu of all existing and proposed incentives. It is still unclear whether the capital acquisitions deduction in lieu of depreciation should be allowed for all investment anywhere or whether after apportionment, the taxpayer should add his Michigan depreciation and subtract his Michigan capital acquisitions. Depreciation or investments capitalized by December 31, 1975 would not be part of the VAT base in either case.

The current proposal also includes the addition of factor payments as the method of calculation of of the tax. This contrasts with the sales tax type credit method in use in most, if not all, existing VAT taxes. Under this method the tax base is total sales with a credit allowed for the tax paid by suppliers and shown on invoices for the purchase of goods and services. No criticism is made of this method but it would not be workable in Michigan where most

of the suppliers of goods and services to Michigan taxpayers are not themselves located in Michigan. Compliance and audit problems would be insurmountable.

Although the European credit method must be rejected it could still be possible to calculate the tax by subtracting from sales the purchases made from other taxable firms. This was the approach of the Michigan BAT. However, several of the state's major taxpayers report that they used the addition method for the BAT tax anyway because it was easier and conformed more closely with the accounts and concepts required for federal income tax purposes.

Several, more practical, decisions also have had to be made on the design of the VAT. These are concerned with the coverage of the tax. The proposal would apply the tax to all economic units in the economy, except government enterprises and non-business, non-profit organizations. There would be no exemptions for certain types, legal forms or size of business. For administrative reasons paper boys, baby sitters, etc. would not be taxed nor would the casual earnings of wage earners. A blanket exemption of all taxpayers with a value added of less than $1,000 is part of the proposal.

Thus, the self-employed would be liable for the VAT but would be permitted to exempt the "undistributed" profit component of their income from the personal income tax. Exactly how this would be done is unclear, but it does seem to be necessary to keep the tax system neutral with respect to legal forms of organization.

Because it is impractical to tax the implicit rent of owner occupied houses, rent paid for residential housing

would be exempt from the tax to assure equal treatment of homeowners and renters.

The financial and insurance industries also present special problems because of their unique accounting and federal tax treatment. Interest paid is part of the VAT base, representing the value added attributable to capital. But in the financial sector interest is also treated as sales receipts. Similar problems exist with interest received by banks. In addition, there is a considerable amount of implicit interest paid (on non-interest bearing deposits) in the form of bank services. Bad debts and other reserves are calculated differently by banks than by other corporations. Finally, there are a variety of financial and quasi-financial firms, some of which have subsidiaries and some of which are subsidiaries of non-financial firms. The use of a VAT in the financial sector is not yet well understood. The current proposal defines the VAT base in the financial sector as rent and labor payments plus residual profits as now defined in the tax laws.

Special treatment of insurance carriers is also needed. The interest problem discussed above is present here as well as problems with loss reserves and interest or dividends paid or credited to policyholders or members. The current proposal plans to handle the interest problem the same as for financial institutions, adjust loss reserves to realistic experience levels and include dividends and interest paid to members or policyholders as part of the VAT base.

Unique accounting practices also may require special provisions to apply the VAT concept uniformly to farming, coop firms, fiduciaries, and regulated industries.

A final practical concern is the treatment of multi-state taxpayers. The former BAT and the current corporation income and corporation franchise tax employ the three-factor Massachesetts formula to apportion income between states. Michigan's membership in the Multi-State Tax Compact will undoubtedly require the same formula for the VAT. The current proposal reluctantly assumes the use of the three-factor formula. Corporate taxpayers would be permitted to file a consolidated return if they do so with the federal income tax. World-wide consolidation would not be permitted (it is currently required).

Draft Legislation

The VAT draft prepared in October, 1972 is reproduced here with only a few changes. The administrative sections have not yet been prepared but would parallel the law for the corporation income tax. Additional legislation to repeal and modify existing taxes would also be necessary.

PROFITS AND PAYROLL TAX ACT OF 1975
December 27, 1974

CHAPTER I

Sec. 1. This act shall be known and may be cited as the "profits and payroll tax act of 1975."

Sec. 2 (1) For the purposes of this act, the words, terms and phrases set forth in this chapter and their derivations have the meaning given therein. When not inconsistent with the context, words used in the present tense include the future, words in the plural number include the singular number, and in the singular number

include the plural. "Shall" is always mandatory and "may" is always discretionary.

(2) Any term used in this act and not herein defined shall have the same meaning as when used in comparable context in the laws of the United States relating to federal income taxes unless a different meaning is clearly required. Any reference in this act to the internal revenue code shall include other provisions of the laws of the United States relating to federal income taxes.

(3) For the convenience of both taxpayers and the Commissioner, the tax imposed by this act has been designed to utilize much of the information required of taxpayers in filing federal income tax returns and to utilize much of Internal Revenue Code and related provisions of the Laws of the United States. However, it is the intent of this act to tax all value-added, unless expressly exempted by chapter 2, originating in or apportioned to Michigan. The term "value-added" shall be interpreted in the sense that that term is used in relation to the National Income Accounts of the United States. The references to the Internal Revenue Code shall not be construed to exempt from taxation any value-added not expressly exempted by chapter 2.

(4) The term "rent" includes lease payments or any other payments for the use without ownership of any property.

Sec. 4 (1) "Business activity" means sales or rentals of property, whether real, personal or mixed, or the performance of services, or any combination of sales or rentals of property and performance of services made or engaged in, or caused to be made or engaged in, within this

state, whether in intrastate, interstate or foreign commerce, with the object of gain, benefit or advantage, either direct or indirect, to the taxpayer or to others, but shall not include the services rendered by an employee to his employer or a casual transaction.

(2) "Business income" means federal taxable income; except that for persons other than corporations it means that part of federal taxable income derived from business activity.

Sec. 6. (1). "Casual transaction" means a transaction made or engaged in other than in the ordinary course of repeated and successive transactions of a like character, except that any transaction made or engaged in by any person which is incidental to that person's business activities, shall be considered to be a business activity within the meaning of this act.

(2) "Commissioner" means the commissioner of the department.

(3) "Compensation", means all remuneration for labor services paid in cash or other medium to, on behalf of, or for the benefit of employees, officers, directors, partners or any individual or entity not itself a taxable or specifically exempt person or an employee, officer, director, or partner of a taxable or specifically exempt person. Compensation includes, but is not limited to wages, salaries, fees, bonuses, omissions, social and self insurance of any kind, payments to individuals not currently working, payments to dependents and heirs of individuals because of current or former labor services rendered by them, payments to any pension, retirement, or profit sharing plan, the economic gain inherent in any stock

options granted and exercised and the remuneration inherent in any merchandise or service discounts and payments for insurance for which employees are the beneficiaries.

Compensation includes remuneration paid in any medium other than cash only to the extent that such payment is not in the form of goods and services purchased from a taxable or specifically exempt person.

Sec. 10. "Department" means the revenue division of the department of treasury.

Sec. 12. (1) "Employee" means an employee as defined in section 3401(c) of the internal revenue code in effect on December 31, 1975. Any person from whom an employer is required to withhold for federal income tax purposes shall prima facie be deemed an employee.

(2) "Employer" means an employer as defined in section 3401(d) of the internal revenue code in effect on December 31, 1975. Any person required to withhold for federal income tax purposes shall prima facie be deemed an employer.

Sec. 14. (1) "Federal taxable income" means taxable income as defined in Section 63 of the Internal Revenue Code.

Sec. 16. "Internal Revenue Code" means the United State Internal Revenue Code in effect on December 31 , 1975.

Sec. 20. (1) "Paid" means and is interchangeable with "accrued" in the case of a taxpayer on the accrual basis of accounting.

(2) "Person" includes any individual, firm, bank, financial institution, limited partnership, copartnership, partnership, joint venture, association, corporation, receiver, estate, trust, or any other group or combination acting as a unit, and the plural as well as the singular number.

Sec. 22. "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country, or political subdivision thereof.

Sec. 24. (1) "Tax" includes interest and penalties unless the intention to give it a more limited meaning is disclosed by the context.

(2) "Tax year" or "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the tax base is computed under this act. In the case of a return made for a fractional part of a year, the term shall mean the period for which such return is made. Except for the first return required by this act, any taxpayer's tax year shall be for the same period as is covered by his federal income tax return.

(3) "Taxpayer" means any person liable for any tax, interest or penalty under this act.

Sec. 26. "Unrelated business activity" means any business the conduct of which is not substantially related (aside from the need of the corporation or association for income or funds or the use it makes of the profits derived) to the exercise or performance by the corporation

or association of its religious, charitable, scientific, literary, educational or other purpose or function which constitutes the basis for its exemption under section 60.

Sec. 28. "Tax base" means business income, even if zero or negative, subject to the following adjustments to the extent related to business activity:

(a) Add gross interest income and dividends derived from obligations or securities of states other than Michigan, in the same amount that has been excluded from Federal Taxable Income, less related expenses not deducted in computing federal taxable income because of section 65 of the Internal Revenue Code.

(b) Add all taxes paid everywhere on or measured by net income or value-added to the extent the taxes have been deducted in calculating Federal Taxable Income.

(c) Add losses on the sale or exchange of obligations of the United States government, the income of which this state is prohibited from taxing, to the extent the loss has been deducted in calculating federal taxable income.

(d) Deduct to the extent included in Federal Taxable Income, income derived from obligations and income from the sale or exchange of obligations of the United State government, which this state is prohibited from taxing, less any interest on indebtedness incurred to carry the obligations and less any expenses incurred in the production of such income, to the extent that the interest and expenses, including amortizable bond premiums, were deducted in arriving at Federal Taxable Income.

(e) Add, to the extent deducted or excluded in arriving at federal taxable income:

(1) Any net operating loss and capital loss carryforward.

(2) Any capital gains related to business activity except gains derived from the sale or dispossession [sic] of tangible assets.

(3) Any deduction for the using up of tangible capital assets, such as depreciation, depletion, amortization, immediate or accelerated write-off of capital assets and unused investment credit deduction.

(4) Any dividends paid.

(5) Any loss due to the expropriation of property.

(6) Any deduction or exclusion due to the classification of a taxpayer as a Domestic International Sales Corporation, Western Hemisphere Trade Corporation, China Trade Act Corporation or any like special classification the purpose of which is to reduce or postpone the Federal Income Tax Liability.

(7) All compensation paid everywhere.

(8) Royalties, interest, all rents, less any receipts from subletting, and any other form of capital or property payments paid which constitute income to the payee except the distribution of residual equity profits.

(9) Any other deduction or exclusion which, if not added to the tax base, would exempt from taxation some value-added not expressly exempted in chapter two.

(10) The proceeds from the sale of tangible capital assets.

(f) Deduct, to the extent included in federal taxable income:

(1) Dividends received or deemed received.

(2) Rent received.

(3) Royalties, interest and any other form of capital or property income received except rent and the distribution of residual equity profits.

(4) Any capital loss not deducted in arriving at federal taxable income.

(g) Deduct the acquisition cost of tangible assets eligible for depreciation, amortization or depletion for federal income tax purposes.

(h) Add the value of all inventories at the end of the taxable year and subtract the value of all inventories at the beginning of the taxable year.

Sec. 29. The tax base of non-profit persons not required to pay federal income taxes shall be the sum of the net additions to, less the deductions specified in Sec. 28.

Sec. 30. The tax base of any person, 90 percent of whose assets are intangible personal property or 90 percent of whose income is dividends, interest or other charges resulting from the use of money and credit, shall not be less than the sum of federal taxable income and the adjusted [sic] provided in Section 28, with the exception of paragraph e, subparagraph 8 and paragraph f, subparagraphs 1 and 3.

CHAPTER 2

Sec. 50. There is hereby levied and imposed a specific tax of ___ upon that portion of the tax base of every person which is allocated or apportioned to this state in accordance with the provisions of Chapter 3 of this act.

Sec. 60. There shall be exempt from the tax imposed by this act:

(1) The entire tax base of any person whose tax base before allocation is $1,000 or less

(2) The United States, this state, other states and the agencies, political subdivisions and enterprises of each

(3) Schools, hospitals, religious and ecclesiastical associations and corporations, homes for the care and maintenance of children or aged persons, and other health, welfare, educational, charitable or benevolent institutions and agencies, operated by an entity of government, a regularly organized corporation incorporated under the laws of the state, when the income or benefit does not inure, in whole or part, to any individuals or private shareholders, directly or indirectly, and when the activities of the entity or agency are carried on exclusively for the benefit of the public at large and are not limited to the advantage, interest and benefits of its members of any restricted group.

This exemption shall not apply to the tax base derived from any unrelated business activity or to any agency or entity currently taxable under the Michigan general property tax laws or substantially organized for the purpose of providing goods or services to its members at a reduced price.

(4) Any value added from the rental of a residential homestead.

CHAPTER 3

Sec. 102. In the case of a taxpayer whose business activities are confined to this state, the entire tax base of such taxpayer shall be allocated to this state, except as otherwise expressly provided in this act.

Sec. 103. Any taxpayer whose business activities are taxable both within and without this state, shall allocate and apportion his tax base as provided in this chapter.

Sec. 105. For purposes of allocation and apportionment of the tax base from business activities under this act, a taxpayer is taxable in another state if, (a) in that state he is subject to profits and payroll tax, a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business or a corporate stock tax, or (b) that state has jurisdiction to subject the taxpayer to a profits and payroll tax regardless of whether, in fact, the state does or does not.

Sec. 115. All of the tax base, other than the tax base derived from transportation services or specifically allocated, shall be apportioned to this state by multiplying the tax base by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3.

Sec. 116. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of

which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

Sec. 117. Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at 8 times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals.

Sec. 118. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the commissioner may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

Sec. 119. The payroll factor is a fraction, the numerator of which is the total compensation paid in this state during the tax period by the taxpayer and the denominator of which is the total compensation paid everywhere during the tax period by the taxpayer. For the purposes of this chapter only, "compensation" means wages as defined in section 3401 of the Internal Revenue Code.

Sec. 120. Compensation is paid in this state if:

(a) The individual's service is performed entirely within the state; or

(b) The individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or

(c) Some of the service is performed in the state and (i) the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is in the state, or (ii) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

Sec. 121. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

Sec. 122. Sales of tangible personal property are in this state if:

(a) The property is delivered or shipped to a purchaser, other than the United State government, within this state regardless of the f.o.b. point or other conditions of the sales; or

(b) The property is shipped from an office, store, warehouse, factory or other place of storage in this state and (i) the purchaser is the United States government or (ii) the taxpayer is not taxable in the state of the purchaser.

Sec. 123. Sales, other than sales of tangible personal property, are in this state if:

(a) The business activity is performed in this state; or

(b) The business activity is performed both in and outside this state and based on costs of performance, a

greater proportion of the business activity is performed in this state than is performed outside this state.

Sec. 131. The tax base of a taxpayer whose business activities consist of transportation services rendered partly within and partly without this state shall be determined under the provisions of sections 132 to 134.

Sec. 132. In the case of such tax base other than that derived from the transportation of oil or gas by pipeline, that portion of the tax base of the taxpayer derived from transportation services wherever performed that the revenue miles of the taxpayer in Michigan bear to the revenue miles of the taxpayer everywhere. A revenue mile means the transportation for a consideration of 1 net ton in weight or 1 passenger the distance of 1 mile. The tax base attributable to Michigan sources in the case of a taxpayer engaged in the transportation both of property and of individuals shall be that portion of the entire tax base of the taxpayer which is equal to the average of his passenger miles and ton mile fractions, separately computed and individually weighted by the ratio of gross receipts from passenger transportation to total gross receipts from all transportation, and by the ratio of gross receipts from freight transportation to total gross receipts from all transportation, respectively. If it is shown to the satisfaction of the commissioner that the foregoing information is not available or cannot be obtained without unreasonable expense to the taxpayer, the commissioner may use such other data which may be available and which in the opinion of the commissioner will result in an equitable allocation of such receipts to this state.

Sec. 133. In the case of the tax base derived from the transportation of oil by pipeline, the tax base attributable to Michigan shall be that portion of the tax base of the taxpayer derived from the pipeline transportation of oil everywhere that the barrel miles transported in Michigan bear to the barrel miles transported by the taxpayer everywhere.

Sec. 134. In the case of the tax base derived from the transportation of gas by pipeline, the tax base attributable to Michigan shall be that portion of the tax base of the taxpayer derived from the pipeline transportation of gas everywhere that the thousand cubic feet miles transported in Michigan bear to the thousand cubic feet miles transported by the taxpayer everywhere.

Sec. 145. (1) If the taxpayer's only business activities within this state consist of sales and do not include owning or renting real estate or tangible personal property and whose dollar volume of gross sales made during the tax year within this state is not in excess of $100,000.00 the taxpayer may elect for that year to report and pay a tax on the tax base arrived at by multiplying total sales in this state for the taxable year by the ratio of the tax base, for the tax imposed by this act, to total sales as reported on the taxpayer's federal income tax return for the same taxable year.

(2) The election is not available for any taxable year for which a consolidated return is required.

Sec. 147. (1) If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commissioner may require, in

respect to all or any part of the taxpayer's business activity, if reasonable:

(a) Separate accounting;

(b) The exclusion of any one or more of the factors;

(c) The inclusion of 1 or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.

(2) An alternative method will be effective only with approval by the commissioner.

Characteristics of the VAT and Taxes to be Replaced

Apart from the level of revenues, taxes have other effects on the economy. Any change in tax laws should be made only after evaluating the change against some criteria of "good tax policy." The following points should be considered.

(1) The neutrality of the tax on market decisions.

(2) The alteration of the distribution of income resulting from the tax.

(3) The effect of the tax on price levels and overall resource utilization.

(4) The ease of tax administration and compliance.

(5) Windfall gain or losses from the tax change.

Since Michigan has the most cyclical economy of any state but is constitutionally prohibited from incurring an

operating deficit, two considerations important to the tax collector must be added.

(6) The income elasticity of the tax.

(7) The stability or predictability of tax receipts.

The corporation franchise tax and the income taxes are clearly non-neutral with respect to legal form of organization and factor proportions. The business portion of the intangibles tax, a tax on accounts receivable, is similarly non-neutral. The same must be said for the insurance premium tax which is an excise tax.

Only the VAT is neutral. This characteristic is elusive but important. Consider the amount of resources wasted annually by altering legal forms of organization for tax purposes and such misdirected use of resources as the report of a company that profited from spending $100,000 to recover, as expected, $50,000 worth of oil.

The impact of business taxes on income distribution is a matter of much dispute. However, there is little reason to believe that the impact of a VAT would be much different from other business taxes. Nonetheless it will be necessary to counter the recurrent argument that the corporate income tax only reduces profits while the VAT is a regressive sales tax.

The State of Michigan, or any state, has little effect on and should not be concerned about macroeconomic stablization matters. The single exception is the effect of the choice of taxes on price levels within the state, which depends on the incedence of business taxes. A priori, the choice of taxes should have little effect. Although the more efficient VAT should, over a period, reduce waste

and hence prices, the switch from one tax to another may cause a one time price level increase. (See below)

The four existing business taxes, as well as the VAT, can be calculated from the financial records business firms are required to keep for preparation of their federal income tax returns. In this sense, none of them impose unusual or difficult compliance problems. However, compliance costs are high for the corporate income and franchise taxes due to legal ambiguities in the definition of the tax base and the availability of optional accounting methods.

A single replacement tax for four existing taxes would obviously simplify both administration and compliance. In addition, hopefully, the VAT base would be more precisely defined, after initial legal tests.

Any significant tax change produces windfall gains and losses. Upsetting the existing economic balance causes the losers to react in a manner designed to protect their position. A single once and for all increase in price levels should be anticipated as those whose taxes rise try, to the extent their markets permit, to maintain their profits.

Despite the obvious fact that windfall effects are negligible in the long run they must be considered as the political process has a high discount rate. A thorough study of the tax liability of various industries before and after the adoption of a VAT has not yet been done. However, it does appear that those industries that would receive windfall gains would be:

(1) Industries earning a higher than average profit.

(2) Capital intensive industries with a relatively small payroll and high corporate franchise tax.

(3) Industries with good cash management and hence relatively little taxable accounts receivable.

(4) Industries with few special tax provisions now paying income taxes at close to the nominal tax rate.

(5) Expanding industries with large capital acquisition deductions.

Unincorporated industries would not benefit from the repeal of the franchise tax but would benefit from the exemption of the "owner's profit" from the personal income tax. In general, corporate firms would benefit more than unincorporated firms from the adoption of VAT.

By definition, the income elasticity of a VAT is approximately 1.0. Permitting a capital acquisitions deduction will alter the year to year elasticity. An elasticity of less than 1.0 would be anticipated in the final stages of an expansion period for example. The tax on accounts receivable has had an estimated elasticity of slightly less than 1.0, presumably due to improving cash management. The insurance premium tax has an elasticity of about 1.0. The income elasticity of the corporate income and franchise taxes are difficult to calculate due to changing tax bases, accounting practices and the timing of payments and refunds. Both appear to have an elasticity of between 0.6 and 0.7.

The receipts from the taxes on accounts receivable and insurance premiums are reasonably stable and not difficult to predict. The receipts from the franchise tax are also stable, although the tax base is continually being

redefined by the courts and by changes in accounting practices.

The corporate income tax is an unstable tax. This fact is one of the prime reasons for considering the adoption of a VAT. Tax receipts are far more unstable than the underlying profits due to unexpected changes in the tax base, by Congress, the IRS, and the accounting profession and the payment options available to taxpayers. The table below shows the instability and the resultant difficulty in predicting revenues.

	Prediction			
Fiscal Year	6 Months Before F.Y.	6 Months Into F.Y.	Receipts	Actual Adj. to Current Rate
1973-74	360	410	385	385
1972-73	315	350	369	369
1971-72	240	265	270	301
1970-71	215	151	149	231
1969-70	270	239	224	262
1968-69	230	274	247	293

In the current fiscal year, the estimate is made difficult by the pending federal tax reform legislation, the growing shift to LIFO inventory accounting, delays in payments to conserve corporate cash, and a switch to consolidated returns. The confidence interval of the estimate is considerably larger than the estimated surplus in the state budget. This creates considerable budgetary problems, given the constitutional prohibitions of a deficit budget.

As stated earlier, this paper is intended to be a first step in the process of developing a workable VAT concept for the State of Michigan. Many relevant issues may have been overlooked or oversimplified, but is our hope that

enough issues have been raised to begin a meaningful dialogue on the Value Added Tax. Only in this way can we hope to avoid the many pitfalls inherent in such a complex undertaking.

APPENDIX B

Brief Biographical Sketch
of
OLIVER OLDMAN

Oliver Oldman is Learned Hand Professor of Law at the Harvard Law School and Director of two programs at the School: the International Tax Program and East Asian Legal Studies. He has been a member of the Law School Faculty since 1955, when he began directing the Tax Program's training activities; was appointed Professor of Law in 1961; and became Director of the International Tax Program in 1964. In 1976 he was appointed Learned Hand Professor of Law. Since 1981 (except for one year) he has also been Director of East Asian Legal Studies. His teaching interests have centered on state and local taxes and finance in the United States and on comparative and international tax law with special emphasis on taxes in the developing countries of the world. During recent academic years he has been teaching the following courses: Comparative Tax Policy, State and Local Taxes and Finance, and The Property Tax. He has also occasionally taught courses on the Public Spending Process and on the Value-Added Tax.

Since 1984 he has also been teaching the new Pacific Community Legal Research Seminar, which emphasizes the international legal aspects of development in Asia. The Seminar is the principal current activity of the Pacific Community Legal Research Project, of which he is Director.

He is co-author (with F.P. Schoettle) of STATE AND LOCAL TAXES AND FINANCE (Foundation Press, Mineola, New York, 1974); co-author (with R.M. Bird) of READINGS ON TAXATION IN DEVELOPING COUNTRIES (John Hopkins Press, Baltimore, 1964; Revised Edition, 1967; and Third Edition, 1975); co-author (with H.J. Aaron, R.M. Bird, and S.L. Kass) of FINANCING URBAN DEVELOPMENT IN MEXICO CITY (Harvard University Press, 1967); co-author (with P.L. Kelley) of READINGS ON INCOME TAX ADMINISTRATION (Foundation Press, 1973); co-author of TAXES ON IMMOVABLE PROPERTY (OECD, 1983); and author of numerous articles in scholarly journals and conference volumes.

Since 1957 he has served as a consultant on tax law and policy to national, state, and city governments in the United States and abroad, and was a member of the Shoup Commission to Venezuela (1958) and the Musgrave Commission to Colombia (1968). He was Director of USAID tax missions to El Salvador (1963-64) and Chile (1964-68). In 1978 he was a Visiting Research Scholar on Local Government Finances while at the Tokyo University Law School. He has recently been an income tax advisor to the Governments of Egypt and Jamaica and a consultant to the Advisory Commission on Taxation and Revenue of the Commonwealth of the Northern Marianas Islands. He is currently Chairman of the Cambridge (Massachusetts) Real Property Assessment Methodology Review Committee, and a tax advisor to the Government of Senegal.

He is currently serving as a member of the Advisory Board of the Inter-American Center of Tax Administrators (CIAT), the Faculty Board of the Lincoln Institute of Land

Policy, the U.S. Council of the International Fiscal Association, the Board of Directors of the National Tax Association, and the Tax Section of the American Bar Association. He is also an Honorary member of the International Association of Assessing Officials. His office address is: Harvard Law School, LW 332, Cambridge, Massachusetts 02138, U.S.A. Telephone: 617-495-4622.

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STATE OF MICHIGAN
IN THE CIRCUIT COURT FOR
THE COUNTY OF INGHAM

CATERPILLAR INC., formerly
CATERPILLAR TRACTOR CO.,

Plaintiff,

vs.

STATE OF MICHIGAN,
DEPARTMENT OF TREASURY,
REVENUE DIVISION,

Defendant.

_____/

File No. 84-9664
-CM and
87-11109-CM

TRIAL
BEFORE THE HONORABLE THOMAS L. BROWN,
CIRCUIT JUDGE
LANSING, MICHIGAN - JULY 28, 1987

APPEARANCES

For the Plaintiff:

DON S. HARNACK, JD
RICHARD A. HANSON, JD
GREGORY G. PALMER, JD
111 West Monroe Street
Chicago, Illinois 60603
312/372-2000

KENNETH T. BROOKS, JD
Suite 200
215 S. Washington Square
Lansing, Michigan 48933
517/371-1730

For the Defendant:

TERRY P. GOMOLL, JD
RICHARD R. ROESCH, JD
First Floor, Treasury Building
Lansing, Michigan 48922
517/373-3203

Reported By:

Teresa J. Gallegos, CSR-3445

PROFESSOR OLIVER OLDMAN

A witness called by and on behalf of the Plaintiff in the above entitled cause having been duly sworn to testify on his oath as follows at 10:35 p.m.:

THE COURT: Please be seated.

DIRECT EXAMINATION

BY MR. DON S. HARNACK, JD:

Q. Professor Oldman, could you give us a brief summary of your background and experience in the area of value added tax practice?

A. I have been teaching about the value added tax in a couple of courses that I teach at the Harvard law school, beginning – it's been 25 years ago. When the Europeans first started getting involved with it, I got interested in it, because I thought the students ought to know something about what goes on its the rest of the world. I have been a follower of the common market.

In any event, I had, on my staff at that time, a woman, Clara Sullivan, one of the economists, who became the author of the leading treatise on value-added tax. It is the leading textbook on value added tax economics, which she did under the overall supervision of Carl Shoup of Colombia University. He is sometimes called the father of the value added tax, because of his presentation of VAT to Japan back in '49, '50. It was because of the Shoup mission that Japan adopted value added tax in its modernized tax system in the 1950s, though repealed in early '60s.

I have also been a member of the American Bar Association Committee on value added tax, which has operated on and off during the past dozen years depending upon the committees Chairman and whether or not Congress might be considering that same time soon.

The value added tax committee has recently reconstituted itself and is now actively preparing a draft value added tax for discussion by the ABA House of Delegates.

I have had a number of students from developing countries at Harvard Law School and they have been adopting this tax in rapid fire order over the past 15 or 20 years. And I have worked with a number of those students in their thinking about the tax, and have therefore had to have, each year, anywhere from three to a dozen classes on the tax. In one year in 1979, when value added tax was being actively considered by the House Ways and Means Committee, when Congressman Ullman was the chairman of that. In that year, I gave a whole course on it for one semester for not only students, but various people from the outside who came to attend.

There never has been – since that time, I think, a course given in that subject in the US. I wrote one article dealing with value-added tax that is published in the American Bar Association, Income Tax Compliance Volume, when they wanted to know something about the relationship between VAT and income tax from the point of view of enforcement and operation.

(Plaintiff's Exhibit Z marked for identification.)

Q. **(BY MR. HARNACK)** I have for you, Plaintiffs Exhibit Z, can you please identify that for the Court?

A. That contains a brief biographical sketch that I prepared with respect to teaching, research and publication activities in the first couple of pages. Then the remainder of pages one through 10 is a bibliography of various writings that I have done over the years of reports, articles, books and so on.

Mr. Harnack: Your Honor, I would like to offer Plaintiff's Exhibit Z.

The Court: Any objection to Z as in zebra?

Mr. Gomoll: No, Your Honor.

The Court: Doesn't the rule provide Plaintiffs' numbers and Defendants' letters?

Mr. Harnack: Your Honor, we couldn't find that rule, we took a 50 percent chance.

The Court: That's always my problem. A 50-50 chance. I am always wrong.

Mr. Harnack: I would only have one comment aside, Your Honor, not to be too humorous, but Professor Oldman is very, very distinguished, and is younger than he looks. He is a classmate of mine.

The Court: I won't make any comments on that.

(By Mr. Harnack) Professor Oldman, in preparation for your testimony before this court today, did you have an opportunity to examine the Michigan Single Business Tax provisions along with the very recent amendment to the single business tax that labeled the tax an indivisible, value added tax?

A. Yes, I have. I might also say I had been acquainted with development of value added tax concepts from way back in the beginning when Michigan first had the BAT in the late '50s and early '60s, when I began teaching a course in state and local taxation. It was at that time a curiosity to which some attention had to be paid. But I didn't say much about it in the book that we use in teaching materials at that time. The tax was repealed and then it came back to life in 1975, '76. Then it became important, again, to say something about it, because at that time the Advisory Commission on Intergovernmental Relations decided it was important enough to do a full monograph on it.

Others were interested – policy makers from other states are always asking me, well, Michigan has this tax, why don't we do the same thing? Therefore, we were required to pay some attention to it. I've never gone into as much detail, as I have been in preparation for this case and really went through the whole statute including amendments, to see how does it really work.

Q. What, if any, nature of reservation do you have about the structure of the Single Business Tax?

A. The general structure of the Michigan Single Business Tax is, and in the recent legislation was described officially in the statute as, a value-added tax. That is a correct way to describe the tax base in terms of its initial computation, in terms of components.

The major reservations I have is that when the tax then tries to deal with the problem of multi-state or multi-national taxpayers, it has to decide what part of the value-added – of the multi-jurisdictional taxpayer is

Michigan value-added and subject to the tax. And it's the methods used by Michigan to do something about the multi-jurisdictional taxpayer, that I have serious reservations about; whether that method is consistent in any way with a basic notion of what the value-added tax is.

Q. Could you describe those basic notions to us?

A. The value-added tax is a modern form of taxation that has come into prominence when the Europeans decided in establishing the Common Market to have one major tax that would be common to all the different countries. It's in the 1950s when you have that development coming forth.

Before that, you have theoretical writings that go back to T. S. Adams of Yale University at about the end of the first World War, suggesting VAT as a means of general finance. And then when the U.S. Treasury was concerned about financing the second World War, there was again some consideration of it, but not until the Shoup mission recommended it for Japan in 1949 did it begin to get a much more public image.

The Japanese adopted it, but then they postponed its going in effect each year for five years, and then after that, they repealed it before it ever went into effect. Many of you probably heard that in the past year the Japanese government has revived the idea. The administration is in favor of having it, but they have been so far unable to get it through the Diet with all of these trade problems.

And the way the tax has been put in operation in Europe, the principle idea of most of the sponsors has been to use the value-added tax as a way to tax personal

consumption as a form of sales taxation, whereby the tax is collected through an elaborate withholding mechanism as goods and services pass through the economy through production and distribution. So as each firm adds something to the value of what it bought, its purchasing, as each firm buys supplies, raw materials, inputs and then combines its labor and its plant facilities, and its profit-making potential and entrepreneurship with its inputs, it then has an output that has a value that is increased beyond what its inputs were.

There are various documents from the ACIR, I mentioned before two more recent statements that might be worth quoting in terms of what value added is, there is the recent Michigan case, the *Kelvinator* case.

And then I think it's worth just quoting the language of one sentence of that opinion. "The SBT is an additive method of value added taxation which taxes the incremental value of the economic activity by adding the factors of a production by which the taxpayer adds value to its purchased goods and services."

That's the same as what the American Bar Association has stated in a volume of collected articles on the value-added tax, in the ABA Tax Lawyer, the publication arm of the section of the taxation of the ABA.

And in the report of the Special Committee on VAT, which had a number of reports, 1971 to 1977, I quote from the definition that was in there, "the tax base on which a VAT is levied is essentially equivalent to the sum of a

firm's profits and payments for its factors of production not subject to VAT – normally interest, compensation, depreciation and rentals paid." That is, the input on which somebody else has paid VAT is not part of the taxpaying firm's VAT. And its profits and payments include normally, and I quote again, "interest, compensation, depreciation and rentals paid."

So these definitions of value added are widely accepted and understood, both by the policymakers, the theoreticians, and the legislators, and the courts, which have said something about it. And if you think of any one firm, the ordinary way to compute its value added is to just take the sum of its profits and wages. Then, depending upon whether the landlords are taxed on rents as value-added taxpayers or not, you might have rent included in the tax base of a firm which pays that, and it would be the one that adds rental value to the product. In Michigan, however, landlords are value-added taxpayers.

Therefore, to the extent that real properties added value to the goods and services that are produced within it, the use of real property for that purpose, that additional to value-added tax base, through the use of real property, is taxed to the landlords. And therefore, when the company pays rent, it's a tax paid input.

So that one way, in that kind of a situation, the content of value added is essentially profits or income and wages, especially if you have the so-called consumption type of value-added tax where the sum total of all the firms' value added is equal to what amounts to the retail price of the goods and services bought for personal consumption of the buyers. If you add up all the value

added, from the original raw material producers to the final retail, the sum total is equal to the price of the retail goods. So one could look, for example, at national income data, and find in the national income accounts the total of personal consumption in the United States in the given year or in France or Germany or any other country, and that total of personal consumption represents the total value added during that year, which was consumed by people for their own personal purposes.

Now, there is other value added during the year by an economy. And that is the production of capital goods. That's real value. As for the existing value added taxes in Europe today as well as in the developing countries of Latin America, Asia and Africa, which have adopted the value added tax, almost every one of those countries uses the consumption type of value-added tax rather than the gross product type, which is analogous to the US GNP.

The gross national product each year is the sum of the personal consumption that year plus the production of capital goods, that's the GNP. The net national product, the net national income, is that first sum, GNP, minus the amount that is used up that year by wearing out in operation. So the net national product is new personal consumption, new capital production minus previous capital that was used up. And personal consumption subtracted from GNP is the total of new capital produced during that year. If you subtract the total of new capital from the total of GNP, what remains is personal consumption.

Now, the practical problem is to find the personal consumption as it was produced and distributed throughout the economy. And to do that you look at each firm's value added and tax each firm only on its value added. You don't tax the firm on value added by one of its suppliers as the supplier, for example, produces tools and fixtures as we heard about earlier. The supplier that produces that is taxed on adding the value to create those tools and fixtures.

Therefore, when you use the Michigan type of value added tax, which is to add together the components of value added, then you look at the firm's income and the firm's labor, principally, to constitute what the firm's tax base is.

Another way to calculate a firm's tax base for the value added tax is to look at its total sales and then subtract from its total sales its purchases from value added tax paying firms, that is, its purchase of VAT paid inputs. That could be rents, it could be assemblies, tools, supplies, all kinds of fuel, for example. Anything that it buys from other business firms would be subtracted from its sales, and the difference between its sales and taxable input is the value added by the firm. That figure is the same as the additive method would give for the same firm. If you add up its profits and wages, and other non-tax paid inputs, that would equal the same thing.

Michigan has chosen to use the additive approach, because it taxes the value-added tax on the basis of where the value was added to the product. The European approach is different. The European approach assigns to the jurisdiction where the goods are personally consumed,

the right to tax the value added that's included in those goods, as is generally the case with sales taxes.

Sales taxes in the U.S. similarly are levied by the states where the goods are destined. And that so-called destination principle governs the value added tax in Europe and it governs sales taxes of the American states in the United States.

Very few jurisdictions use the other general type of value added tax where you assign to the jurisdiction the right to tax the value added within its jurisdiction, rather than the value added consumed in it jurisdiction for personal purposes.

The states of Brazil are, to my knowledge, the only other place in the world that regularly use the origin type of value added tax. There, each Brazilian state is required to do so under a national law. Each Brazilian state taxes each firm that operates within the state on the value added that that firm produces within that state on an origin basis. When those goods are shipped to another state, the other states then tax the additional value added that might be added to the product, if it is brought into the second state before final sale for personal consumption. Each state keeps revenue based upon the value added within each state, unlike the members of the European common market where each country keeps value added tax revenue in proportion to what is personally consumed in each state, which means that each country in Europe, when goods leave the country, they have the value-added tax removed from them.

Any value added within a country with value taxes, says, in France where goods are produced, when those

goods are shipped to Germany, the exporter gets a complete rebate or refund of every franc of value added tax that is paid by him or his suppliers.

When the goods enter Germany, Germany imposes its value added tax at the border upon the value of the goods at the time they come in. Then if they receive further processing, retailing or distribution services, the additional value added in Germany is subject to tax in Germany. So that approach, which is to tax on a destination basis, is used internationally.

The origin approach is used within a country and Brazil is now the only country that uses the value-added tax at the state level. India has been talking about using that tax for the Indian states, but it does not now do so. A number of American states have talked about doing it, but Michigan is the only one that has an operational law. West Virginia had a tax that went through its legislature, but was vetoed by its governor. Michigan remains the only state that has the tax and it taxes on the origin basis and uses the additive method for computing.

Sorry if I went on too long on that.

Q. No, I think the background is very helpful, when we get down to your description, just what is the Michigan Single Business Tax. You say it's origin based and uses the additive method. Could you describe your understanding of precisely how Michigan creates its VAT tax base?

A. What Michigan does, and it's somewhat similar to what Congressman Ullman had proposed to do when a

Federal VAT was proposed, is to start off with tax information that Michigan taxpayers already have. The starting point on the Michigan SBT or VAT is to look at the Federal taxable income of a taxpayer and then use that as the profit element. The SBT then makes some changes to the profit, as well as adds to it labor wage or compensation costs, which are the major components of the value added tax bases. Income or profit and wages are the two main components of the Michigan value added tax. The rent and interest components are taxed directly to those firms which add value by way of rent, or by way of using property, real property, or which add value through the borrowing of funds, so that the banks get taxed in Michigan on this additive basis unlike the way they are treated in Europe, but like the way they are treated in one or two other countries, such as in Israel.

So for a Michigan firm, you start off with its income, not its income tax, but its income as reported for Federal tax purposes. And then to income is added the wages. But because the income comes under the Federal tax law, it includes allowance for depreciation, which is not a part of the value added tax base.

Federal income has the depreciation deduction removed from it for purposes of the Michigan SBT, and that's removed by adding back to the tax base the depreciation that's been deducted for Federal tax purposes.

So what remains of income is what might be called income for value added tax purposes, which is the usual view of what income is, subtracting all the usual costs of goods sold from gross receipts with the exception of

depreciation, which is an accounting concept for how to account for capital goods.

But since the value added tax that tries to tax only consumption does not tax capital goods, you want to remove capital goods from the tax base altogether. And the way to do that with respect to the depreciation element of capital goods, if you start off with Federal taxable income, is just to add it (the cost of capital goods) back in. That's what the Michigan tax does. It also makes a few other adjustments to Federal income tax accounts, which are necessary in order to get what you might call pure value added income. And it makes those changes as well.

All of that is necessary in order to get the concept of value added ingrained into the base, which Michigan is trying to do. It has announced it has a value added tax and tried systematically to identify for each firm the figures in its accounts which add up to or constitute components of value added. The problem that arises is when you have multi-state and multi-national companies. You start with Federal income, you get rid of the depreciation, you bring back in all the wages. That's the crucial computation that is involved. But a company that has wages, compensation outside of Michigan, then has to get some kind of consideration given to its worldwide or countrywide accounts. It has to have something done to its countrywide or multi-national or worldwide accounts in order to identify which parts of the company's value-added was done in Michigan, how much of the company's total value added was added in Michigan. And there Michigan uses as a unique approach by just carrying over its old income tax apportionment formula and saying, well, we will just apply that three-factor formula of

property, payrolls and sales to the value added tax base, meaning income plus compensation. That's a strange animal in the world of value added tax thinking.

In the world of value-added tax, you know where most of the value added is, in fact, added, because you know where the workers are. So you don't have to use the formula, you take the wages paid for services performed in a location, and say that's the value added by compensation in that area. If you are interested in taking the value added by property, you would then look to where the property is, where it's being used, so you would know where it is and you could calculate its rental. If it's rental property or rent is paid, you know where the rent is. That's the value added that year for that company.

But where, as the Michigan tax purports to do, you are not taxing the rental value of capital, you have excluded capital from the base. In a sense, you can say property is not really relevant to the value added tax base, except as it annually contributes to the output and contributes to profit, so to speak. And in that sense, property production leads to gross receipts in the end. Services and property render, year-to-year, greater sales, and that becomes a component of your profits and that's how it adds to your value added. But you are not taxing the machinery and equipment and billings directly under a consumption type of value added tax.

Q. What effect does inclusion of the sales factor as part of the SBT three-factor formula ordinarily have on the preapportioned taxed base?

A. Well, sales represent, you might say, the consummation of the entire value adding process. The sales price

of goods represents the total value added by the firms that sell those goods, plus value added by all the firms which supplied input to the taxable firm that we are now taxing. So the sales of the firm include not only its value added, but also the value added by the firm's suppliers.

If what you are trying to identify is the location of the firm's value added, then sales – the location of sales would basically be irrelevant. It's the components of value added that you are trying to locate, not the sales. The sales are the sum total, the result of the value adding process. But the sales don't tell you where the value was added. Therefore, it's an extraneous factor to determining the geographical location of the value added. The components are the profit and the wages. They are the primary components. The wages can be located easily by knowing where the work was done. So one doesn't need a formula at all for that.

Income, even the value added concept of income, which is without depreciation, that is gross receipts minus cost of goods sold, without depreciation, even that concept of the income is not so easy to pinpoint geographicaliy. A firm's income is the result of a lot of activity in different places, including even some sales activity. Therefore, it can be seen that income can be subjected to some kind of a formula in order to get a rough approximation of where it arose.

It would be easy to identify the place where income arises, if all you are talking about is a piece of real estate that is rented; the location of that pinpoints where that income is from. But where firms are engaged in multi-state and multi-national activities, it's more difficult to

decide where the geographical location of the firm's income is, even though it's easy to decide where its payroll or compensation is located.

For value added tax purposes, it seems to me much better to eliminate the sales factor from the three-factor formula in trying to geographically pinpoint where the income arises in a value added sense and property and payroll can be identified with the value-adding process. In so far, however, as you are not trying to tax the value added by property, payroll itself is all you really need for the purpose of deciding where the income element of the value-added tax base is located.

One might look at payroll as the key item in a tax like the Michigan tax, where payroll is the major component of the tax base.

Q. Have you had an opportunity, Professor Oldman, to review some of the litigation that has resulted in the application of the SBT, the *Jones & Laughlin* case?

A. Right, I have read the *Jones & Laughlin* case, The *Kelvinator* case, the *Trinova* case, but it is the *Jones & Laughlin* case and *Trinova* case are the ones that involve these issues of apportionment of geographical location of value added and of trying to pinpoint the extent to which value is added in Michigan and therefore subject to the Michigan SBT. The result in the *J & L* cases seems, to me, to be a sound one, and a necessary way of interpreting and applying what the Legislature inserted into the Act by way of geographical division of the value-added tax base provisions. It generally has its three-factor formula, but then it has safety or relief provisions in order to cover

the multitude of cases where the three-factor formula doesn't conform to reality.

So the statute allows for other methods to be used than a three-factor formulation and the relief provisions that are there would allow, for example, the separate accounts for payroll to be used to identify the geographical location of value added by payroll and compensation. Since the Legislature provided a scheme that allows for flexibility for the value added to conform to reality, then it would seem as if it's the obligation of the Department of Treasury in Michigan and the courts to make that work. If the Department of the Treasury applies the statute in a way in which an artificial result is achieved as was proposed in the *J & L* case, then the Courts come in and bring reality into the picture, and say, quite correctly, that you can't locate where the payroll element or components of value added are by looking at where the sales took place, or where the sales ended up.

You locate payroll by looking at where the people worked. The Court there came out with a pragmatic result which accords with the reality of that taxpayer's accounts. Seems to me that a system which allows for that kind of flexibility, if administered that way, solves the problems of the multi-state or the multi-jurisdictional taxpayer by judicious interpretation and application of Section 69, which provides this wide range of possible applications of the geographical division of value-added tax provisions.

Q. Probably better stated, at least than by me. It provided that prior to the recent amendment to the SBT, which would appear, would it not, in your opinion, to

place a limitation on what the administrators can do with that Act?

A. That provision – the amendment is very short. To my mind, the most useful thing that it does is to reconfirm that the Legislature had in mind a value-added tax concept in the first place. The original statute didn't use the language of value added tax in the statutory language, although all the legislative history indicated that's what they wanted it to do. The amending the statute, which is curative, it reaffirms, it now puts in the statute, that it's a value-added tax. The fact that it is an indivisible value added tax does not add anything. Any tax is an indivisible tax, it's a value-added tax, it's not a gross receipts tax, it's not a sales tax, it's not a some other tax, it is a value-added tax. And the word indivisible there doesn't clarify anything that wasn't there previously, in my judgment, in terms of the value added tax concept.

Q. As I understand your testimony, then, it would be your opinion that the sales factor is not appropriate for utilization in the value-added tax?

A. Right, it is my opinion that the sales factor, that sales themselves, represent the ultimate goal of the value adding process, and that to use that to geographically locate where the value was added provides a misleading geographic picture of where the value-adding process takes place.

When a jurisdiction purports only to tax value added within its jurisdiction, that originates within its state or country, and it has taxpayers who operate in more than one jurisdiction, it has to face up to the problem of geographical division of the tax base. The way to do that

is not by looking at where the sales take place, you use sales to apportion gross receipts taxes, and you use sales in conventional corporate income tax as a handy representation of the demand factor in producing profit. But to use sales in the value-added tax is almost a contradiction in terms, because it's not really related to the value added tax process.

Q. Do I also understand your testimony to be, that it's your opinion, that only those items which cannot be specifically sourced to a given jurisdiction would be appropriate for the application of a formula?

A. Right, where the information was for a component of value added, such as compensation, or if depreciation were to be made a component, that if one knows the location of a component of value added, then the accounts that show that give all the evidence that one needs of that value added. With respect to the more intangible types of contact or components of the value added tax base, then one might want to use proxies or formulas to make an approximation of where the value added tax base is. And for that purpose, you want to look at value adding processes, production and distribution processes. Where they take place, where people get paid, and where property is used to generate value.

Q. Professor Oldman, I am now going to state a hypothetical question to you. If you have any questions at all relative to the facts, don't hesitate to interrupt me.

A. I may take some notes if there are some numbers.

Q. Let's assume it's the year 1981, we assume that a taxpayer, in this case Caterpillar, has neither production facilities nor distribution facilities in the state of Michigan. Assume that Caterpillar's Michigan property in 1981 has a total value of six million dollars, and its total property throughout the world is six billion dollars, resulting in a property factor of 1/10th of one percent attributable to Michigan. Assume that Caterpillar's Michigan payroll is 79 thousand dollars.

A. 79 thousand?

Q. 79 thousand dollars.

A. Right.

Q. And Caterpillar's total payroll is 2.5 billion dollars resulting in a payroll factor of 3/1000th of one percent attributable to Michigan payroll.

Assume further that the sales of product into Michigan are 70 million dollars and that total sales of Caterpillar worldwide are 7 billion dollars resulting in a sales factor of approximately one percent attributable to Michigan.

Assume that the average of these three factors is approximately 3/10ths of one percent.

Assume further that by use of the three-factor formula, the Michigan Revenue Department computes compensation taxable in Michigan. The amount of compensation is thereby increased from 3/1000th of one percent, that's based on the actual compensation paid in Michigan, to 3/10ths of one percent, an increase of 100 times, not 100 percent. An increase of 100 times.

A. From 3/1000ths of one percent?

Q. To 3/10ths of one percent.

A. To 3/10ths, which would be 100 times?

Q. 100 times. Assume that the property factor, which otherwise would measure the use of personal property in the state, is increased from 1/10th of one percent to 3/10ths of one percent, an increase of three times. Those are all the facts I am preparing to submit to you at this time; do you have any questions?

A. It's quite clear.

Q. I haven't asked a question. I just want to know.

A. I have questions about the facts.

Q. You have questions about the facts?

A. No, I think I have got them down right.

Q. Do you have an opinion as to whether or not the statutory method of apportionment contained in the single business tax, using the three-factor formula, properly reflects the values added by Caterpillar's activities in Michigan?

A. I do have an opinion, and it seems to me quite clear that the Michigan three-factor formula applied to these facts brings about results completely inconsistent with the idea of the value-added tax on an origin principle using the additive method. The way you know that is that the payroll compensation is 79,000 in Michigan. To use the compensation factor or to use as the compensation component of value added, any figure beyond 79,000 would misrepresent Caterpillar's value added within

Michigan from the use of labor. That would be a total misrepresentation. The measure of it is the 100 times factor. It's 100 times greater than the value added through the use of payroll and compensation within the state, and it's a clear distortion of what a value-added tax base is trying to identifying in a geographical sense.

One could say the same thing with respect to depreciation to the extent depreciation of property enters into the tax base. There you have a three-times multiple in relation to the six million of property that's within the state. And instead what gets attributed essentially when you increase from 1/10th of one percent to the 3/10ths of one percent is six million becomes 18 million. And that doesn't make any sense in the context of the value added tax.

Q. I take it, then, it is your conclusion that utilization of the SBT three-factor formula in this case would result in a taxation of values out of all appropriate proportion to the company's value added in Michigan, which is used to measure its business activity?

A. It's completely out of appropriate proportion to its value-added activities within the State of Michigan as compared with its value-added activities outside of Michigan.

Mr. Harnack: Thank you, Professor Oldman, that completes my direct examination.

The Court: Mr. Gomoll?

Mr. Gomoll: Can we have a short recess.

The Court: Sure, 10 minutes?

Mr. Gomoll: 10 minutes would be fine.

(Recess from 10:20 a.m. to 10:30 a.m.).

The Court: Mr. Gomoll?

Mr. Gomoll: If it please the Court, on cross-examination of Mr. Oldman, Mr. Roesch is going to do the initial cross-examination.

The Court: All right, Mr. Roesch?

CROSS-EXAMINATION

By Mr. Richard R. Roesch, JD:

Q. Professor Oldman, you testified that you had familiarity with the business activities tax, which was levied from '53 to '67 in Michigan. Could you explain to me how the tax computation under the business activities tax was made?

A. Under the old act?

Q. Yes, the business activity tax 1953 through '67?

A. I did not go back and review that specifically, recently. But I do have recollection that it looked – it brought in some of the value added tax kind of thinking in the design of the base at that time.

Q. That was not my question. Let me put the question directly. Was it an additive-type tax?

A. I guess I don't remember, but I think if I had to think back, I would say that it was – I just don't remember what it was at that time, but it would be easy enough to take a look at it.

Q. Yes, it would be easy enough to find it. You testified there were several ways of – there were at least two ways of measuring value added by the enterprise, the additive method, and then you also spoke of the deductive method.

A. Subtractive.

Q. Subtractive method, correct. Professor, are you familiar with the Supreme Court case in Michigan in 1961 under the business activities tax, *Armco versus State of Michigan*?

A. I have read that case, yes.

Q. If I gave you a few examples, the last question you answered was a hypothetical, based upon facts which are peculiar to Caterpillar, and as I remember them, the facts were assuming that we had property of 1/10th of one percent in Michigan. Those were the exact facts in *Armco* also, sir.

The next was assume that we had 3/1000ths of one percent of payroll. I would only make variation here. Assume it were 1/40,000th rather than 3/1000ths, 1/40,000th of payroll.

A. 1/40,000th of one percent?

Q. Yes.

A. Okay.

Q. And on the sales figure, instead of using one percent, we shall use 8.7 percent. And now I shall ask you, under those circumstances, would an attribution of tax base to the State under the business activities tax,

which was this forerunner of the SBT of 2.9 percent, slightly above 2.9 percent, which is the sum of the three factors divided by three. Would that, in your opinion, be an improper measure of Michigan activity?

A. Assuming those figures are correct, and the 2.9 percent is the average, and that that's the way it was reached, would I say it would be improper? Yes.

Q. But you are perhaps familiar with the outcome of *Armco Steel* case of the Michigan Supreme Court, which was in favor of the VAT, would you disagree with that outcome?

A. Yes.

Q. You testified as to the amendment just recently made to by Public Act 39 of this year, to Section 69 of the single business tax. You specifically said that very little was added by the idea that this is an indivisible value added type of tax except to characterize the tax as being in a different concept, and the privilege of earning that income, for example; am I correct in saying that?

A. Well, I did not talk about the privilege.

Q. No.

A. Not at all. And what I was characterizing was the base of the tax, which has the name single business tax.

Q. Yes.

A. And has various other language. But in terms of identifying what the base is to which the tax rate is ultimately applied, the Amendatory Act says this is a

value-added tax, and that's not news, because it's always been referred to as a value-added tax.

Q. Correct. But it does use the word indivisible.

A. It does use the world indivisible, right.

Q. And it uses perhaps in contrast to and not a combination or series of several smaller taxes?

A. That, to me, is a contradiction in terms.

Q. That is as contraction in terms?

A. Right.

Q. Is that a contradiction because you believe you can source value added by looking at the elements of the tax base?

A. Correct, that's correct with respect to those components of value added such as compensation, and such as depreciation with respect to tangible goods, with respect to both of those, you know, and can identify from the records where the value is being added through where the people are working and where the property is being used. So to the extent that they are a part of the tax case, the geographical sourcing is almost – is self-identified.

With respect to those parts and those components that go up to make up the sum total of value added, it may be helpful to use approximations or formulas with respect to others. But with respect to those two, those are two easily identified geographically, to justify the use of any kind of a formula instead of the specific allocation where they are.

Q. Professor, both the ABA, you spoke of the committee on value-added taxation, and the court case in Michigan that you read from, would you agree that a value added tax is upon incremental addition to value, I will call it incremental additions to cost, between when a product comes in my door and when a product leaves the door. In other words, it's upon the incremental value added at any stage or production or distribution; is that correct?

A. By someone who is identified under the Act as a taxpayer?

Q. Correct.

A. Yes.

Q. And if there never is a disposition or sale of a product, is there any activity subject to taxation?

A. As a conceptual matter in terms of the value-added tax base, you have to face the same kind of problem that you face in income taxes with the concept of realization and what to do with it, and the accounting device that deals with that is inventory, and both income taxes and value added taxes in the end have to decide how to handle inventory in terms of not whether it is value-added, but when is value-added going to be taken into account for the purpose of applying the tax right to it.

Q. Yes. You are familiar with the single business tax. Do you remember offhand the definition of the word "activities" in that tax?

A. I know it's in there, but I don't remember the precise definition.

Q. Well, the definition is basically, in terms of the transfer of legal or equitable title to property, so forth, before a single business tax liability arises. My question is, must there be such an activity, namely sales, when we are talking of products rather than rendition of services?

A. The answer is yes.

Q. So sales is important as to the single business tax; is it not?

A. Sales is important in terms of identifying in which year, in which tax time period, value added is going to be accounted for, and it's important in the sense of realization that you have something to measure, but it's not the amount of the sale, it's the occurrence of the sale.

Q. Professor, what is in the single business tax, what did the Legislature identify as the taxable subject?

A. The tax base?

Q. Not the tax base, but the taxable subject.

A. What difference do you intend?

Q. What is the taxable subject under the New York franchise tax? What's the taxable subject under the New York franchise?

A. In other words, it's the franchise.

Q. It's the franchise. And yet when you go to the base, what is the base?

A. The measure of the tax may be income or it could be gross receipts.

Q. Correct, in other words, it's a tax for the doing of business measured by net income. Now, I go back to my question, the subject of the tax here, what did the Legislature identify as its – as the subject that it was reaching?

A. The idea of a single tax on business.

Q. Yes. In fact, the taxing statute says this is a tax upon the doing of business and not upon income, specifically, income tax. Michigan is the only state that has a doing business tax based upon a value added principle.

A. Yes.

Q. Other states, what do they use?

A. Income and gross receipts are the two most frequently used measures of business activity.

Q. I see. And in those cases, let's say in the New York franchise statute, how is the privilege of doing business by a multi-state enterprise divided up? How is it attributed to the state?

A. Since the base is income, they then have the problem of the geographical division of income of the multijurisdictional taxpayer. And that then gets divided up by formulas. Not all states have exactly the same formulas, but all the income-taxing states use a formula, and those formulas always have relief provisions in because the possibility of a formula is always that it might not work in a particular application. So there are relief provisions to depart from the formula where that seems to be appropriate.

Q. Do the majority of states use a three-factor formula?

A. Yes, they do. They also use special identification for particular types of income that are easy to identify like real estate.

Q. The business/non-business dichotomy, which authorized your division, I presume you are referring to the Michigan apportionment formula in the single business tax, basically, a copy of that in the uniform division of income for tax purposes act?

A. I don't think I would call is a copy, but it has many similarities to it. And indeed its derivation was in connection with its former income tax and the apportionment formula in its former income tax was just carried over to the VAT whether or not it was thoughtfully carried over or carried over because it was available and nobody wanted to worry about designing a custom made formula for the VAT. But in fact its source was not a design for VAT, its source was designed for income tax.

Q. Did the former – well, we touched on it before, did the former business-activities tax also contain the three-factor apportionment formula; did it not?

A. Yes, it did.

Q. And the franchise tax for the privilege of doing business in Michigan –

A. Also.

Q. – also had that formula. And indeed the intangible tax upon business which also was replaced; did that also have a three-factor formula?

A. I haven't looked at that one, but it wouldn't be surprising to find out.

Q. It did?

A. Because it's for intangibles where these formulas have its greatest use.

Q. Would it surprise you to be told that in 1965 all Michigan taxing statutes on business were amended to insert therein that you had the three-factor evenly weighed formula, I am just asking, would that surprise you?

A. No.

Q. So it actually predated the Michigan income tax?

THE COURT: Is that a question?

MR. ROESCH: Yes, and he nodded and the answer would be . . .

THE WITNESS: Well, predated one.

Q. **(BY MR. ROESCH)** The Michigan income tax 1968?

A. Well, there was a Michigan income tax even before that.

Q. No.

A. Is that the first one?

Q. 1968, January 1, corporations, October '67 on individuals. Section 69 of the SBT, the relief provision. What is its purpose?

A. To identify – to allow the taxpayer and the administration to bring in other methods of geographically

dividing the value-added tax base where the statutory three-factor formula does not accord with the facts of that particular firm.

Q. Is the Section 69 a relief provision?

A. In my judgment, it's a combination of relief and accuracy of the supervision. In other words, the objective is to get at where the value added is added and the language of the provision is to give a necessary flexibility in that process.

Q. Is it supposed to respond to unique circumstances or just to the run-of-the-mill cases?

A. It's supposed to respond to whatever a case demands. Whether it's by industry, by company, it's supposed to be responsive to the situation. And not necessarily unique to any situation where the three-factor formula doesn't do, doesn't properly or only geographically divide the base.

Q. Professor, we have 7,000 multi-state single business taxpayers in the state. They all have a compensation component of the base. Under your analysis of sourcing, should each one of these 7,000 separately account for compensation?

A. To the extent that the separate accounting for compensation produces a result that is significantly different from what the three-factor formula produces, they should separately account.

Q. Aren't we really – are you not really turning a tax on the subject of doing business into a tax on compensation, a tax on depreciation, a tax upon interest paid,

rentals paid? In other words, are you not subdividing the tax by your source and theory?

A. The Michigan statute defines what the measure of the tax is, which is valued added and value added consists of those components which are also identified by the statutes. I am not changing anything. I am just making consistent the application of the concept of the tax base to the multi-state taxpayer.

Q. Let's go to the subtractive method for a minute. What if, instead of the additive method, the single business tax had the subtraction method, just as it had under the business activities tax; what would your answer be then? Couldn't you separate – would you strictly account for compensation, but just not add it up with the other elements?

A. When a jurisdiction wants to do what Michigan wants to do, which is to have origin based value-added tax of the consumption type, then you would have to take – you would have to convert the subtractive method for those taxpayers for whom your approach to dividing up the tax based doesn't produce a proper result. Then you would have to look at what the components of that taxpayer's tax base would be, because you're looking at the countrywide or worldwide accounts when you are using the subtractive method. And to locate where that value was added, you would then have to have more information once you decide that's what you want to do. It was Michigan that decided to do that, and then got itself in this situation.

Q. In other words, let me get this straight, under a subtractive type computation, a subtraction computation,

you would still say since the difference, the end result done here on the subtraction is the value added, and since I can say that value is added by compensation, by interest paid, by profit, by depreciation, would you still make the same argument that one should source the value added?

A. I would make the same argument, unless the system that you were using was the system that the European countries and that other countries use, which is to say that the value added is only going to be taxed to the place of consumption.

If you are going to use an origin type approach, which Michigan said that it wanted to use in large part in order to employ a measure of the services provided for government to business, and they look at value added as one way of approximating the benefits that businesses get from that the value added in Michigan, approximates the benefits measure of the benefits that businesses get from government expenditures, and that's a rational approach to it, and you build that in to the cost structure, but it does require identifying value added in Michigan.

Q. In other words, when you're saying rational consistency leads you to the result that Michigan has an origin based consumption type additive method value-added tax, and logic consistency, therefore, permits sourcing the elements, permits us to look, in other words, as you put it, where the value's actually added?

A. Just to straighten out where logical consistency begins and ends, it's the Michigan statute that decides if they are going to use the origin approach, not logical consistency. That's a legislative determination that they

want production and distribution activity when it takes place in Michigan to be subject to a state tax, whether that activity is engaged in by corporations, partnerships, individuals, it doesn't make any difference. But if it's in Michigan, then the value added will be measured and will be subject to tax. And if that system is to be adopted, then to be consistent with it in terms of geographical division of the tax base, sourcing by looking at specific components is the best way to start off.

Only where you don't know the source of the components, would you then look to the design of the formula, that gives you a reasonable approximation for that component. And it's there where the logical consistency is once you decide to have that kind of tax base, and in my judgment the rest follows.

Q. Is it not possible that the Legislature simply said for the privilege of doing business instead of an income tax, instead of a net worth tax, we will have a value added type tax, value added no matter where in this world, a portion thereof attributed to Michigan; isn't it possible that that's what they say?

A. Anything is possible for a legislature to try and do. Whether it is successful in doing that in terms of getting the willing cooperation of taxpayers, on the other hand, and whether it's successful in avoiding Congress' constitutional barriers to their tax policies, that's a different question. But if the Legislature wants to design something that was non-existent before, whatever kind of a label it puts on it, that's neither an income tax, nor a gross receipts tax, nor a value added tax, but we want it

and we will define it this way. If they want to do it, they can do this, then they take their risk.

Q. Professor Oldman, do you believe sourcing constitutionally is required?

A. In the case of the value added tax, I think that that properly, that's a result at the state level, if the tax is levied at the state level and the origin approach is used. In other words, if what Michigan says it's doing is what they want to do, then I would think that a result that's consistent with those components of the value-added tax, which can be sourced, would be constitutionally required.

Q. A state is free to choose its tax system, is it?

A. Within constitutional limits. Therefore, it can satisfy itself with an income tax, franchise tax, gross receipts tax. It can choose any one of these. It can use easily any of those taxes that have already been used and have already been defined and litigated so that we know what the dimensions are. When you do something different, then you are charting new territory.

Q. So Michigan doesn't have an income tax, does it, on corporations?

A. On corporations?

Q. It doesn't have an intangibles tax on corporate portfolios and it does not have a franchise tax, does it?

A. I don't know.

Q. No, it doesn't. It replaced all these with a single tax, a single business tax. The Legislature was free to

choose to do that. Whether or not they did is, of course, subject to constitutional challenge.

A. Right.

Q. Caterpillar does business from Illinois and Illinois has not chosen a value added tax, but has chosen to measure their activities and to tax them by an income tax. How do they apportion to Illinois their income?

A. I suppose that Illinois uses a three-factor formula.

Q. Correct.

A. But they also must, if they are going to use an income tax, they have to use an income tax not only for multi-state taxpayers, but for all taxpayers and Michigan can use an income tax too, but they have to use everything, they can't pick out-of-state payers for income tax and in-state ones for value added tax.

Q. In fact, what does Michigan do? Do we impose our value-added tax, our single business tax on instate as well as out-of-state industry?

A. Sure, you apply it to everybody. But the rules aren't always exactly the same.

Q. How are the rules?

THE COURT: Break for lunch.

MR. ROESCH: Sure.

(Lunch break from 12:00 to 1:30 p.m.)

(Court, Counsel and all parties present.)

THE COURT: Please be seated. All right, Mr. Roesch.

Q. **(BY MR. ROESCH)** Professor Oldman. Is capital employed in production, property employed production, is that one of the sources of income?

A. It's a source of adding value to products as the capital gets used up.

Q. Correct. You also testified that an apportionment by a three-factor formula of income seemed logical. Now, is it logical because property contributes to production of income and payroll does and so does the marketplace; is that the idea?

A. In the case of income?

Q. Yes.

A. Geographical location. The three-factor formula is not so much logical as it is a practical compromise, which is workable as long as you have a mechanism for dealing with the case that it doesn't fit. So it's a starting point. It's not by any means an acceptable finishing point to say that income taxes in all cases should be apportioned by a three-factor formula. That would not be logical.

Q. So it isn't a relationship to the source which makes the three-factor employable in determining income of multi-state corporations?

A. It's a rough attempt to get at the source, not by measuring it receipt by receipt the way Federal income tax law does in separate accounting, not by the way all countries do through separate accounting. But the states long argued that that's too difficult to apply because the rates are relatively small to justify maintaining auditing

staffs to regulate the transfer prices used in separate accounting.

It's a complex matter. With the rates low, you accept the compromises that are generated by three-factor or two factor formulas. Some states use four and five-factors, you accept that compromise as long as the rates are small and the impact on the tax liability is not so great as to make the taxpayer upset enough to complain or make the administrator upset enough because the formula happens to produce very little revenue and what should be done is separate accounting, as the administrators sometimes assert and claim under the income tax. That's why I say that a three-factor formula or indeed any formula is not a logical complete solution to the geographical determination of income in the income tax area.

Q. In other words, it is just a very rough approximation of, I don't want to use the word source, very rough approximation of source?

A. Of source, it is exactly what it tries to do. You are trying to identify the source in each state, which will then become the tax base. You can do it bit-by-bit or as a whole. If you do it by formula as a whole, you run the risk of distorting a particular taxpayer's geographical division of income.

Q. Now, in your words, you had reservations, is the exact word, reservations about the Michigan three-factor formula applied to a value-added tax.

A. I think I said a major reservation.

Q. Would you have a major reservation if net income were judged by one factor alone, namely, the marketplace, by the sales?

A. I would have a reservation that it would be undesirable to apportion net income only by the sales factor. That doesn't mean that it might not work in certain cases. But to say that it would be a model to be set up for adoption, say, by all of the 50 states, I would think it inappropriate.

Q. Indeed you have said the majority of states use the three-factor?

A. Right.

Q. Is that what you meant by model, basically?

A. Many of them, but some don't go for the business/non-business distinction, they just put everything in one pile.

Q. Yes, I understand. Are you familiar with a *Moorman* case? *Moorman* versus –

A. *Moorman Manufacturing*?

Q. Which upheld a net income tax apportionment with a one-factor formula; is that right?

A. Yes, but it did uphold it in a context in which the taxpayer did not show that it was being treated differently in other states, so as to cause a disproportionate tax being imposed by either. In that case it was all done on the face of the statute.

Q. Professor, does not the Supreme Court in a footnote of that case point out 44 states use a three-factor

formula? In other words, other states did treat them differently, they did not use a one-factor formula?

THE COURT: Is that a question?

MR. ROESCH: That's a rhetorical statement that is a question.

THE COURT: I didn't hear an answer.

THE WITNESS: They pointed out other states have different formulas, what was not in the record in that case was how it applied to a particular taxpayer to lead to an unconstitutional result. There was no evidence on that.

Q. (BY MR. ROESCH) I understand. The Supreme Court in that case said that the taxpayer had not overcome the presumption of constitutionality. They had not shown there that there was unconstitutionality.

A. But the Supreme Court, in the *General Motors versus District of Columbia* case, said that the use of a one-factor sales formula was not good, but there it was interpreting the District of Columbia statutes enacted by Congress and not ruling as a constitutional matter.

Q. What were you saying, that the privilege of doing business includes the privilege of manufacturing?

A. Yes.

Q. So the employment of capital, that would be included?

A. Yes.

Q. And the employment of labor?

A. Yes.

Q. And it also would include the making of sales, would it not?

A. Yes, but I suppose it requires some elaboration. To note that when a statute uses language like privilege, even through that's now outmoded by the *Complete Auto Transit* case, or when a statute more importantly uses language like business activity, that statutory language is in there for the purpose of showing to the world that there is a legal basis for asserting the power to tax, that the government is entitled to get paid for services which it renders. It is the earning of income or the generating of economic activity which is the subject of the tax.

But having identified a reason for taxing to cover the costs of government service that was benefiting business, then the Michigan statute, as do other statutes, whether they are privilege taxes or otherwise, then go on to define how that right to tax is to be exercised in terms of defining a tax base, and then a rate which is going to be applied to that tax base. The relevance of privilege and of business activity is only to provide the necessary legal excuse for taxing in the first place. After that one must look at the design of the tax that the law provides for measuring what the tax liability is going to be. Having decided that, you can tax.

Now the question is, how do we do it. And in this situation, the tax we have before us today, the single business tax, their value-added tax, the value-added base is the avowed measure of the right to engage in business activity, which is an acknowledged proper excuse for asserting the tax burden.

Q. I fully agree with you. And we also know what the value added is of any enterprise, we know what the worldwide system value is; do we not?

A. Yes.

Q. And Michigan then purportedly uses an apportionment device to get its share of the value added worldwide.

A. But Michigan defines its share in a very peculiar manner. And, in my judgment, in a very discriminatory and biased manner by including the sales factor in it. The sales factor has the effect with respect to instate producers in Michigan of diluting the importance of their payroll and property in Michigan by using a sales factor to take out of Michigan a part of the payroll and a part of the property, to take them out of the tax base, because there are sales outside of the State.

The converse happen with respect to out-of-state producers. They, under the Michigan statute, are forced to bring into the instate tax base a proportion of their out-of-state payroll and property that is measured by their sales in the state. And the effect, the combined effect of the way the sales factor works, is to, in my judgment, generate a discriminatory result as between the way the tax impacts on in-state producers and out-of state producers.

Q. Isn't this the same argument that was made in the Willis report of 1964, once you do away with the sales factor? Are you familiar with it?

A. Very much.

Q. Isn't the Willis report –

A. But the Willis report, in terms of which factors to use, got into the debate largely between groups of economists, but also others practically involved with apportioning interstate income. They got into the debate over the extent to which income is supply-side activities, production, or demand-side activities, the creation of the market.

The Willis committee in the end came out with the recommendation that the best way to apportion interstate income is by a two-factor formula, property and payroll. They rejected the inclusion of the sales factor largely on administrative and practical grounds.

As a whole, when you look at the country as a whole, the only thing that's really important for the efficient operation of the United States common market is that there be a uniform system and the uniform system could be a three-factor formula for income. But then it wouldn't be administered properly. And therefore they went for a two-factor formula because they thought it could be administered uniformly as well as have an overall uniform division of the base.

Q. Which leads me to another question. When we speak of the sales factor, were sales always attributed to the destination state? If sale was made from Ohio to the state of Michigan, was it always attributed to the destination?

A. To this day there is disagreement of the states as to which state the sale should be assigned to for purposes of including it in the numerator of that state's sales factor. While the predominant rule is destination, it's by no means the uniform rule.

Q. Indeed, I would ask you, we mentioned the New York franchise tax measured net income. Prior to 1965, how did it treat inter-state sales, sales from one state into New York, or from New York out to New Jersey?

A. I don't recall 1967 being a change year for New York, but apparently it was. It may have been the year that – I am not even sure what their current sales factor is, that they had changed it.

Q. The current sales factor is the destination sales factor?

A. It's destination, but the question of weight on it.

Q. It's evenly weighed. No, my point that I was going to make was this, in the Michigan franchise tax, in the original business activities tax, sales were attributed 50 percent to origin, and 50 percent to destination. And that was the New York treatment also.

My question that I have is this, were not the practical difficulties in devising uniform formulas behind the idea of getting rid of a sales factor and going into a two-factor in the Willis report, was that one of the major considerations?

A. It was not so much reducing the number of factors, because they could have made it sales and property or sales and payroll. It wasn't a reduction from three to two that was important.

The problem was the disagreement over the meaning and interpretation of the sales factor, plus the fact that almost any interpretation of the sales factor, except an origin based one, would attribute sales to some states that could not or would not exercise jurisdiction. The thought

was that some of the income might therefore fall in a nowhere land and not be taxed by any state. This subject is what eliminated the sales factor. Because with property and payroll, there would always be jurisdiction by any state that would have property or payroll jurisdiction to tax, they would use the two-factor formula. So 100 percent, no more and no less of the tax base, would be apportioned among the states. If they fell in a state that didn't exercise its right to tax, then there would be no tax by that state on their share of the national tax base.

Q. But even today, the majority of states still apply the three-factor formula, still true?

A. Yes, still a confusing situation as described in the Willis report as of the early 1960s. The situation continues unabated because Congress has not yet acted in this.

Q. Are you familiar with *Ford Motor Company versus Beauchamp*, B-e-a-u-c-h-a-m-p?

A. No – I am not familiar with that, we didn't happen to discuss that.

Q. Yes, are you familiar with the apportionment factor or factors under that Texas franchise tax?

A. I haven't looked at that tax in particular.

Q. Your strong reservations with apportionment of value added are due to the fact that you believe you can source or you can assign to a certain state components of value added?

A. Yes, in particular, the payroll, which is the most important source of value added. It is the most important

component of value added. It's one which can be geographically pinpointed very easily with the exception maybe of some marginal cases of a few individuals who may be constantly on the move.

But with that exception, the geographical location is easy. Similarly with respect to the extent to which property adds value to a firm's output, and property does have that characteristic, even after the depreciation adjustment, and after the capital acquisition deduction still the property does produce as it gets used up. And to the extent that property yields value-added tax base, it, too, can be specifically located.

Q. How many states in the union accept a separate accounting or a sourcing theory for attribution of tax base?

A. Are you talking about income tax now?

Q. Talking income tax. Talking franchise tax.

A. But the franchise taxes, for the most part, are income taxes. Only in few cases are they based on capital stock. Maybe one or two cases measure by gross receipts. And in those cases, the formulas are generally used as the method for geographically dividing the base.

Q. Okay. I will give you a hypothetical. I have a taxpayer who has 10-percent of his property in Michigan, 10 percent of his payroll in Michigan, 10 percent of his sales in Michigan. He also very typically has 80 percent of the value added as compensation element. In that event, how would you allow the state of Michigan, or how do you think that the state of Michigan should tax this particular taxpayer?

A. In this case, given those figures of your example, it makes no difference whether the three factors are averaged together to make 10 percent or whether you just look at the 10 percent payroll factor, and apply that to its tax base, which is 80 percent payroll compensation anyway.

And that's why Michigan can enact a three-factor formula, as a general starting point and presume that in a case, even if it isn't the average normal case, the factors may be fairly evenly distributed. If, when they get averaged together, the differences are relatively small, you don't bother trying to refine for those differences, you just apply it and the result in terms of tax burden is not very different, whether you use a direct source, a specific allocation, or a three-factor formula. The problem arises in the example that we had in the testimony earlier, where each of the three factors are dramatically different than each of the other two.

Q. We will make it simpler, we will make it one percent property, one percent payroll, and 10 percent sales in Michigan. And once again, 80 percent is the so-called compensation component.

A. It's – in that case, as I said before, that averaging those three together, which would give you an average of four percent, where that would distort the value-added tax base, that can be identified as in Michigan. This taxpayer has his – well, in this case with the one percent, we know that its main place of production is out-of-state, because ninety-nine percent of property and payroll are out-of-state. So in that case, what is happening is the ninety-nine percent of property and payroll are out of

state. The State is saying we are nevertheless going to treat it as if there is only 96 percent out-of-state, and the other four percent we are going to say is instate.

Q. But are we taxing compensation, is the state of Michigan purportedly taxing compensation?

A. In that example, Michigan is taxing, in very real terms, not only compensation, but out-of-state compensation, which constitutes 80 percent of the value added tax base. That's exactly what it's doing and that's the whole trouble, that's the distortion.

Q. But that doesn't mean anything when the Legislature says indivisible value added, meaning the overall value added.

A. In my judgment it makes no difference, because when you are taking 100 percent of the value added or 80 percent of the value added, you can't very well say that that four percent of the payroll is in the state when ninety-nine percent of it is out-of-state. And it's a contradiction of reality to produce a result that's inconsistent with the facts.

Q. It's a contradiction of reality if I had a tax upon the payroll, would it not be?

A. A tax on value added is a tax on payroll to a very important extent.

Q. This is where we disagree. A tax on value added is a tax upon the incremental markup at any stage of production.

A. And that's largely constituted by payroll. The markup is, in your example, where there is an 80 percent

payroll, 80 percent of the markup is due to payroll, to compensation.

Q. That is when you look at the – that is purely a sourcing theory?

A. It's a fact, it's a fact. You don't need a label legal or otherwise on it. 80 percent of the difference between sales and taxable input is compensation. And that's what the books show. And that is the heart of value added.

Q. So what you are really saying is, if Michigan imposed an income tax for the privilege of doing business, it can use a three-factor formula?

A. If it imposed an income tax.

Q. Or if it imposed a franchise tax, as it did?

A. It could use a three-factor formula.

Q. And yet because it says it imposes a value added tax, the words, these many words, value added tax, all of a sudden disallows the state to use the three-factor formula?

A. Exactly.

Q. That's what you are saying? You were referring earlier to *Auto Transit, Complete Auto Transit*. What case did that specifically overrule?

A. The *Spector* case with respect to direct taxes on the privilege of engaging in business.

Q. The *Spector* case. Because the *Spector* case was a tax imposed upon the privilege of doing business interstate, intrastate, because of the label. The *Spector* decision went against the state of Connecticut; did it not?

A. Right.

Q. And so looking beyond the label, *Complete Auto Transit* says we look beyond the label of what the tax is, we look at how it overrules *Spector*.

A further question, is your disagreement with the Michigan single business tax based upon your perception that it – that the formula unfairly attributes to Michigan, or is it based upon your idea that application of the three-factor formula is unconstitutional?

A. I am not sure that there is a difference between those two. But the three-factor formula is inconsistent with the idea of value added as a way to measure where the geographical location of value added is.

Q. With the idea of geographical assignment of the value added?

A. Right. What Michigan says it's doing and wants to do is tax only the value added that is in Michigan. It's a tax on value added in Michigan.

Q. Is that what the law says?

A. That's what the law means. I think in reading the law, that's what it says, that it's a tax on business activity measured by value added in Michigan.

Q. It's tax upon the doing of business, measured by business activities in turn measured by value added, I agree. Value added apportioned to Michigan.

Then by apportionment formula, I go back to *Moorman*. If income arises from the employment of property, payroll and sales, how can a court find an apportionment

formula constitutional takes no account of any property, no account of any payroll, and very simply zeroes in on sales?

A. It's the peculiar posture of that case as presented to the Supreme Court that brought about that result. The Supreme Court is not saying that that's good. It's merely saying that given the way that case appeared, Iowa can get away with doing it, and I think that's the way one has to understand it. And if you are asking me will Michigan likewise get away with what it is doing here with value added tax, I will be very skeptical. It's enough different from *Moorman* that this case or another case like it should go to the Supreme Court. It is going to be a battle, unless Michigan interprets its statute. The way of the *J & L* Court of Appeals, which is the nice way for the Court in the end to rescue the Legislature and Department of Treasury in terms of interpreting the statute.

Q. I disagree entirely with the way the *J & L* Court did it, the *J & L* Court rescued nobody. And I think in the end –

THE COURT: I thought we were involved in questions and answer.

MR. ROESCH: Right, but incomplete opinion as to what the courts do.

THE COURT: I guess that's arguing.

Q. **(BY MR. ROESCH)** I am not about to argue. To revert, Michigan had a corporate income tax whereby income was the base, and it was apportioned to Michigan by an evenly weighed three-factor formula of property, payroll and sales.

A. Yes.

Q. And that was okay. And had a franchise tax on the doing of business, which used a similar formula, or the same formula. And it had a tax, a property tax, upon the ownership of intangibles of the portfolios of corporations, for example, which the single business tax did replace these taxes; did the single business tax replace the income tax?

A. The same act repealed all of those and introduced single business tax.

Q. Yes. And this tax, because it is labeled a value-added tax, may not use the three-factor formulation to apportion worldwide value added by a business by multi-state or multi-national business; is that true?

A. I am saying that a value-added tax, when the origin approach is being used rather than the destination approach, as used in most other places, that if you are taxing value added having its origin in Michigan, then it's completely inappropriate and inaccurate to use a three-factor formula with respect to a multi-state taxpayer. And that the value-added tax base is enough different from the income tax that you can't just skip from one to the other both, as a matter of theoretical design of the tax, and I think ultimately as a matter of the way the Federal system works, in terms of its constitutional dimensions.

Q. But if every state of the union has an income or franchise tax, and uses a three-factor formula, and Michigan, instead of an income or franchise tax, has a single business tax, with a three-factor formulation, does that result in multiple taxation?

A. It's not the inconsistency between other states' use of income tax and misuse of the VAT that causes Michigan any problem. What causes Michigan a problem is that for a variety of reasons it decided that it did not want a corporate income tax. Yet it wanted to raise that amount of money by some other measure.

The VAT offered an opportunity to expand the tax base beyond corporations to include partnerships and individuals engaged in all kinds of economic activity including the rendering or providing of services. So, the tax base could go well beyond the income or the value added of corporations to the value added by anybody engaged in business in the state. That gave an opportunity to broaden the base and lower the rates. And that meant the companies that might be subject to heavy tax liabilities under the income tax during the years when their profits were high would avoid that ever happening to them. They would pay consistently low taxes whether or not they made profits, because the tax base would always include the payroll and the value added through the use of this property. It would give some stability to the revenue that income taxes don't give. It's one of its decided advantages. It would reduce discrimination between corporate forms of doing business and partnership and other forms of doing business. It was another advantage, and it was an advantage to see all business or activity pay its fair share of government cost through taxation in good years and bad years.

So it's the idea behind it. That's all. I think wrapped up in the single notion of this is a tax that's on business activity of all kinds.

Then came the problem at some point, and there I just don't know what went on in the mind of the designers at the time. They had to decide, well, what do you do about taxpayers who are engaged in multi-jurisdictional activity. For the ones who are only within Michigan, it's no problem. Their entire property, payroll, their entire value added, in whatever form is going to be subject 100 percent to the tax anyway. There the law was designed to provide special forms of relief for some Michigan taxpayers. Because when they computed their tax liability under a general value-added tax with origin, some taxpayers found that the tax base was more, for example, than 50 percent of their gross receipts, and the tax looked more like a gross receipts tax than a value added tax. So the Legislature acted then and said, well, if your total value added is in excess of 50 percent of your gross receipts, we will limit the tax base to 50 percent of the gross receipts.

Then other taxpayers came along and said, look, we have all this production going on in this state. We are the lifeblood of the state. Our payroll is 90 percent of our value added, and if you tax us, we won't be in such a good competitive position. And the State accommodated them by saying that to the extent that their compensation payroll exceeded, at first, I think it was 65 –

Q. Three –

A. Sixty-three percent. Then ultimately exceeded 65 percent. To the extent that compensation exceeded that, you could reduce your tax base in order not to be taxed on any more than 65 percent of your payroll, that's an accommodation to those taxpayers. They did that. While

it's a generally available provision there, they were alert to that, because instate taxpayers were in there figuring things out and they came in with their complaint. Farmers came in with theirs and you have the detailed structure of the statute taking care of all the political pressure points, except other state taxpayers were either asleep at the switch or weren't listened to.

Q. Were you around the day when –

A. No, I wasn't around.

Q. So this is a certain amount of speculation?

A. No, some of it was written up when you read the legislative background of political debates as written up in a number of different articles. You have to look far and wide for anybody writing about how did the three-factor formula come in there, other than saying they had it in there.

Q. Let's go back. You said before Michigan had a three-factor formula in its franchise tax, in its income tax, in its tangible tax. And since these taxes were repealed, it has gone in the single business tax so the three-factor formula – was the three-factor formula specifically designed for the single business tax?

A. Not at all, at least so far as I know I haven't seen anything that says it was. Since it's a copy of what was there already, I take it for granted it was not designed for the SBT.

Q. In fact it's something else than the 50 percent gross receipts limit. You said you were familiar with the business activities tax. Did the business activities tax, did it also have a 63 percent gross receipts limit?

A. I just don't remember. I know there was an adjustment for payroll.

Q. Excess compensation?

A. Right, excess compensation.

Q. Would it surprise you if I told you it also had a 50 percent gross receipts limit?

A. I wouldn't be surprised at all.

Q. It's another approach. I asked you once before when using the subtractive method starting with gross receipts, and then starting with all the payments for the material, supplies, and then took the difference, as value added, your argument would still be that you can attribute value added geographically?

A. It's a short method of computing value added and it's the method that in fact is used by other countries in large part because they don't use any form of apportionment at all. What they do is they use that and you calculate the tax. If the goods are going to be exported, you get the tax back. If the goods stay in the country, the tax is paid, so there is never any occasion to worry about which jurisdiction is taxing except in export/import sales, and then it is 100 percent in and 100 percent out, it's never apportionment.

Q. Is the idea of sourcing compensation, is that the same as saying one can separately account for compensation?

A. Right.

Q. That's the same?

A. It's another way to verbalize it.

Q. Has separate accounting ever been required under any state tax, to your knowledge?

A. Yes. Some of the statutes give the tax administration the power to institute separate accounting for particular taxpayers where the tax administration thinks the formula gives the wrong result and in some states the state has the power to impose it with the taxpayer not having any choice.

Q. Is formulary apportionment a rule and separate accounting the exception, or is it the other way around?

A. That also varies from state to state. It's not uniform. Mostly, formula apportionment is the starting point. And then to the extent that that seems to produce a result that is unreasonable in the light of a particular fact, you look for relief. Whether it's a different formula, or using separate accounting, or some combination, all of these are possibilities. The starting point is much more often the formula than separate accounting in the American states.

Q. Are you familiar with Michigan cases of *Payne & Dollan* and *Donovan Construction Company*, cases under our single business tax?

A. I have just seen the summaries of them in the Michigan Compiled Laws, in the annotated versions, but I haven't actually read those particular cases.

Q. Would you have any inkling whether these cases deal with the question whether the formulary apportionment is the rule?

A. In so far as I have heard about the world of construction activity, for example, where construction companies have long been used to using a different method of accounting, completed contracts, separating one job from another, or in some cases they even create a separate corporation for each job, when that happens there may be much less problem than where it's just an accounting arrangement, and then the question is, will the State of Michigan recognize when a large construction company separately accounts for a particular contract, which involves Michigan, and keep out of their accounting for value added tax purposes, all the rest of their construction business around the country and of the rest of the world. And there I understand Michigan has been willing to use the separate construction contract as an operable basis for computing value added.

I wouldn't be surprised to find that analogous to the uniform business concept under income tax treatment, that Michigan has also said that where a conglomerate, for example, has several different kinds of business activity altogether, that Michigan might treat each one of those separately, and account for its value added separately, rather than force the company to aggregate all of its unrelated and independent different lines of business activity. I can see that happening. To me that just illustrates that the problem is an endemic problem.

What I am saying here is that in any other situation where the facts are at odds with the results produced by the formula, then Michigan must also recognize that as different and design an arrangement to accommodate that. And the proper arrangement, it seems to me, is some

form of special allocation, when it becomes easy to identify components of value added as payroll and property.

Q. From your experience, would you judge whether of the 7,000 multi-state taxpayers, a large number or only a handful could show by a sourcing or separate accounting theory entitlement to Section 69 relief?

A. I would expect a significant portion to find that they would have – that they would see a discrepancy between the result dictated by the application of the formula and what their books show with respect to property and payroll.

I would also suspect that some of those companies, of the 7,000 companies, find that inadvertently the tax base is much smaller than they might have expected it to be, because they happen to be in a situation where they have some more payroll and property in Michigan, because it's a state where they acquire but don't sell much. And even though they are not Michigan companies, Michigan may be the location of where they get and produce certain kinds of things, and that those companies would find that like a big instate Michigan producer, they find their tax liability under the three-factor formula is less than it would be if property and payroll was specifically apportioned and then of course they are not going to say anything about it at all, they are pleased as punch. They are bound to be some of the 7,000 who are in that category.

You will not hear from them although the administration might identify some of them and find that it's not getting enough revenue from them. I say I can't blame them because it's Michigan value added. They have the

payroll and property there but they don't sell in the state. They bring it (the product) to another part of the company (outside Michigan) where it gets embodied in a further state of processing and sold somewhere else. They have no sales in Michigan at all in that kind of a case.

And the sales factor then takes 1/3 of their property and payroll, because their sales in Michigan is zero, it takes 1/3 of the property and payroll and apportions that outside the state, so the tax base is less than it would be if you just taxed them on value added as measured by property and payroll in the state. They are very pleased with it. Why Michigan's tax lets them get away with it, I don't know. I would think Michigan is a good place to produce.

Q. Are you familiar with the capital acquisition deduction of the single business tax?

A. To some extent. I read about it.

Q. Does Michigan use a different formula for figuring the capital acquisition deduction or does it use a three-factor formula?

A. It uses a two-factor formula of property and payroll.

Q. It does?

A. Right.

Q. That is specifically provided for by the Legislature?

A. Right.

Q. The Legislature makes any provision for a one-factor or two-factor attribution of compensation element?

A. I don't recall seeing that. No, there may be some exception in some of the cases, but I don't remember seeing it in the statute.

Q. In other words, the tax base, as such, except for the capital acquisition deduction, is apportioned by a three-factor formula?

A. Right, and the capital acquisition deduction is a subtraction from gross value added. It's not a strange subtraction in a state that presumably wants to encourage development in the state. What is surprising is that they didn't except the producers of the capital in Michigan from value added tax at all. But because they are taxed, they (the state) then again has to get the tax burden out of the tax base and the benefit is given to the buyers of these capital goods.

Q. My point, Professor, is the Legislature knew very well to use a two-factor formula for one thing, for the capital acquisition encouragement. But they made no provision for variation from the three-factor to any element of the value-added tax base; am I correct?

A. I am not sure how the two-factor formula got in. But looking at the two together, it seems like a conscious and deliberate decision, which then makes the distortion and the result in the use of the sales factor that I pointed out deliberate, rather than accidental.

Q. So no deliberate attempt was made to give compensation element any different treatment than a profit element of value added or any other element?

A. Right.

MR. ROESCH: Correct. Terry, do you want to take over? Thank you.

THE WITNESS: Thank you.

THE COURT: Further cross-examination?

CONT'D. CROSS-EXAMINATION

BY MR. TERRY P. GOMOLL, JD:

Q. Professor Oldman, I want to try and clear up some things. I think one of the things that Mr. Roesch was getting at, is under the business activities tax, the state of Michigan uses the subtractive method for determining the tax base. And under the single business tax, the State uses the additive method. Does it make any difference in your analysis which method is used?

A. Either way, you have to make some adjustments for the accounts that are, in effect, the starting point for the taxpayer's taxes, and the additive method allows the easy use of your Federal tax accounts as a starting point.

And when you are doing that, the natural thing to do, rather than starting with gross receipts, if you are starting with Federal income tax base is then to add to the income component of value added the other components, and that's what the statute proceeds to do.

So it's an orderly, sensible way to do it. And mainly, in the end, when you compare the two closely together, to figure computations and calculations, it also allows the Legislature to make more special exceptions, if it wants to for certain combinations of value added components,

whether for farmers or manufacturers, or professionals or others.

Q. I guess what I am focusing on in the subtractive method, there is no mention of compensation. We start with gross receipts and subtract costs of goods sold.

A. It's a shortcut for identifying compensation plus profit and some other components.

Q. There is no mention of compensation. Does that make any difference to your analysis when you use the subtractive method or additive?

A. No.

Q. Some of the commentators have described the value added tax as a measure of the economic size of the business. In an article by Mr. James Haughey in the Wayne Law Review, he said the Legislature desired to establish a neutral tax system which leads to business paying tax in proportion to its economic size without interference from the nature of the tax in internal business decisions.

Another commentator, Mr. Lewis Kasischke stated in the same law review, "Theoretically, the SBT is a value added tax and a measure of the tax is the use of labor and capital. The tax base computation is designed to calculate the contribution each business makes to the total economy. In economic terms, this contribution is the economic size of the business. Each business will pay tax proportionate to its economic size." Would you agree with that type of analysis?

A. I have no quarrel with that because, in what you read, economic size is defined in terms of value added, so

economic size is a proxy for value added. As long as that is true, you are not talking gross receipts, gross assets or gross anything else. Economic size defined in terms of value added is stated to be, and I agree that it is, a proper place for reflecting the participation, you might say, of a big firm in the economy. And I have no problem.

Q. Well, let's look at it, then, from this perspective. The Legislature has indicated specifically that the tax is on the privilege of doing business, and the measure is the value added, or the economic size. Okay. So the Legislature says, Well, we are going to tax you on the privilege of doing business and measure it by economic size.

Now, as you testify, there is a problem with multistate businesses. We can't tax on the full amount of value added on this ball of wax called value added or economic size, so we have to find some way of attributing part of that to Michigan. And they say, well, the method we used before is a three-factor formula. So we are going to take this total value added in the economy and slice it up by the three-factor apportionment formula. We are not trying to source components of the value added tax, this whole ball of wax, we are not trying to divide it up in into components. We are going to take this whole thing and say so much of this value added is assigned to Michigan by the apportionment formula. Is there any problem with that analysis?

A. Yes, as I indicated, the entire thrust of my testimony is that it's inappropriate to use the sales factor in making that kind of apportionment of value added, even though the sales factor may have some contribution to

the income in an income tax or to some aspect even of the income components of value added.

But with respect to the other parts of value added, which is the heart of the value-added tax, sales really have little to say, except to the extent that sales people are on the staff of the company, working in Michigan and doing the selling themselves. Unlike what we heard described with respect to Caterpillar, where Caterpillar turns over the saturation of the Michigan market to an independent dealer, and Caterpillar staff only has two, three, four people who service them, and the customers then all have the value added through the selling operation of Caterpillar's product. All of that is value added by the dealers and, of course, that's 100 percent subject to value added tax by Michigan and quite appropriately so.

And if Caterpillar decided to have its own dealership, a wholly owned dealership rather than use an independent dealer, then all of the value added now added by the independent dealer and taxed by Michigan would become part of Caterpillar's tax base and Caterpillar would have no quarrel with that because that would be their value added, but that's already paying tax, it's just been handled by the dealers in that sort of situation.

And the sales activity of Caterpillar in Michigan is virtually negligible in terms of the value added components. You have the salaries of a few people that are involved, and that contributes to sales. But the real sales activity is carried out by others whose value added is subject to tax.

Q. You say one year Caterpillar sales to the Michigan customers are 93 million dollars. Now, that's not the amount that each customer sells?

A. They sell much more than that.

Q. Yes.

A. And the differences between the 93 million the dealers in Michigan pay, and what they get from what they sell, which might be another 50 million. They might get 150 total, so the difference between the 93 and 150 would be 57 million of additional value added in Michigan, a combination of profit sales, payroll, facilities for storing and selling, so on. All of the value added between the time Caterpillar sells into the state and the time when the dealers resell is already subject to tax.

One might theorize, for example, the possibility, and I am sure that there are some states where this might in fact be true where Caterpillar has no presence at all in terms of property and payroll. But nevertheless, a great – a significant volume of its products are sold in the states. An independent dealer in state knowing about the nature of the demands for Caterpillar products just orders and buys them from Peoria and takes over care of them, as we heard before shipment, FOB Peoria.

Anyway, so the independent dealer instate buys from Caterpillar and resells, so on. In that case, Caterpillar has no value added in the state and the state would have no basis for applying value added tax.

Indeed, Michigan law would not apply because the nexus provision under Michigan law would not apply to Caterpillar under that situation. Because Caterpillar does

have a little bit of nexus in the form of a few employees and some property it owns, it then finds itself in the position where it's legally required to file the value added tax return, and it does so. At that point it has to identify what is the value that Caterpillars adds in Michigan. And that value is very easy to measure. The property and the payroll were put on the record earlier today and it's very straightforward.

Q. I think we are – the analysis I was looking at, we were looking at this value added as one solid concept. You are now breaking it up in component parts of Michigan value added. We are going to measure the business privilege by this total value of wax called value added, we are not going to divide it up into compensation and depreciation. We are not going to try to source it. We are just going to divide it, attribute to Michigan by using a formula, apportionment three-factor formula, which is used in most states.

A. On the one hand, you say you are not going to divide it up, Michigan is not going to divide it up, in the next breath you say, Yes, we are going to divide it up geographically among the states. To say you are going to divide it up for one purpose and not for another purpose is unequal. It's a way to get more measure, and it has to be examined in that kind of context.

Q. Well, in an income tax concept, do Federal constitutional requirements require states to source income?

A. The Federal constitutional requirements only say that the states must apportion or allocate the income in some reasonable way. And then the Court has ruled on one after the other, a large number of formulas used in

the income tax context. Some it struck down, some it's upheld.

Since there haven't been any value-added tax cases put before the Court, we don't know what in the end they are going to say there. But there is no reason to assume that what's right for income tax is going to be constitutionally right for the value added tax.

We have seen in the income tax when you compare with income tax cases and sales tax cases and gross receipts tax cases, you find you can't apportion gross receipts taxes by a three-factor formula. For example, gross receipts taxes and sales taxes are on an all or none proposition or basis.

Q. I want to focus on income tax. Say Caterpillar has a large plant, a manufacturing plant in Ohio. And it sells the plant. It has a large capital gain. Makes a lot of income off that. Can Illinois include that income in a tax base which Illinois taxes even though we know who the source of that income is?

A. To the extent that that's a small part of its total income during the year in question, you end up with essentially de minimis problems. To the extent that in that year, that would be the only element of profit in that year; suppose that all the rest of its activity yielded a zero income loss result and that the only income it had that year was the capital gain from the sale of property in Ohio. I would think that the Supreme Court would strike down the application of the three-factor formula to that income.

Q. Has it done so in any case that you are aware of?

A. I am not aware of any case that's presented that problem, but I don't know any state that would be foolish enough to assert the tax in that kind of case. That's why Section 69 type relief provisions are found in all of the income tax statutes when it comes to apportionment in the different cases.

Q. Back to my analysis on the value added as one ball of wax. Now, you are saying it's made up of component parts. But just suppose the Legislature looked at this as just one way to measure. We are not looking at compensation that goes into it. But this is one ball of wax and the Constitution requires the states divide that up. Michigan can't tax the whole thing. So they either require separate accounting or some type of apportionment device. So the Legislature says, Well, we will just take this ball of wax and apply our apportionment formula to it. Is there anything wrong with that analysis?

A. As I said before, I think it's completely wrong to use the sales factor in that kind of apportionment.

Q. Now, in that context, in that regard, you testified that the use of the sales factor shifts the tax burden from instate producers to outside producers, which sell into Michigan; is that correct?

A. It reduces the tax burden on instate producers. It dilutes, really, the measure of the property and payroll in the state of instate producers. And it exaggerated the amount of property and payroll in the state of out-of-state producers. And in that sense, it's a discriminatory application of an apportionment factor, that it evidently has the result of favoring instate production, and of burdening out-of-state production.

Q. Isn't that criticism applied to any state which uses that three-factor formulation? When you have a sales factor, the effect of the sales factor is always to reduce the tax burden for instate producers and increase the tax burden for outstate producers?

A. But only with respect to income, rather than with respect to the components of the value-added tax base. And that's enough difference that in my judgment it's wrong to use that kind of a formula, when what you are apportioning is not income, it's only with respect to income where you can accept the use of three-factor formulas to apportion.

Q. But you have the same effect, it reduces the instate?

A. Right, it does have the effect.

THE COURT: Let's takes a 10, 15 minute recess.

(Recess taken from 3:00 to 3:10 p.m.)

THE COURT: Please be seated. All right.

Q. (BY MR. GOMOLL) Professor Oldman, just as a general rule, is the use of apportionment formula, which shifts the tax burden from instate producers to outside producers, per se, unconstitutional?

A. I am not quite sure what that means. It would raise a question, at least, that would bring into discussion whether or not the reason for the shift and the way it actually operates turns out to be an unfair method of apportionment.

Q. Okay. Is the use of sales, the effect of the sales factor, to shift the burden from instate producers to out-of-state producers?

A. Shifting the burden from one to the other isn't, I think, quite the way I put it, or that it should be put. The use of the sales factor has the effect of reducing the tax burden on instate producers from what it would be if there were no sales factor. And at the same time, it has the effect of increasing the tax burden on out-of-state producers from what it would be if there were no sales factors used. If one would look at where the value added has its origin and use that as the norm, then the standard effect of the sales factor is to benefit instate producers and to put the burden on out-of-state producers. But to say it shifted from one way to the other, reducing one and increasing the other, in a way, that is discriminatory.

Q. You are saying it's discriminatory, but it has the same effect in income tax?

A. But in income tax you are measuring something different.

Q. Forget the base.

A. In income tax you don't know where the income has its source. In the typical case, if you knew where it had its source you wouldn't be able to use the formulas either. In the value-added context, most of the value added, namely the payroll, you do know where it is located, where the value is added to the firm's value-added tax base. And since you know that, you can't artifically live by statute, deny it, and say we are not going to treat it as if it's out-of-state at all. We are going

to move it into the state for the use of Michigan taxpayers.

I seriously raise the question of the constitutionality, it changes the tax from the value added tax genre to some new invention without a name, so to speak, because nobody else has tried to do it. To me, it's a deliberate distortion of state practice in taxes in order to accomplish an unconstitutional advantage, in my view.

Q. It wasn't an answer to my question. The question was, by the use of the sales factor, in any apportionment formula, whether it's income or franchise, the franchise measured by that income, or franchise measured by net worth, doesn't the use of the sales factor shift and increase the tax burden of out-of-state producers and reduce the tax burden of instate producers?

A. The use of the sales factor in effect brings in sales as a part of the tax base. Since sales are not a part of the value-added tax base.

Q. I didn't mention value added tax.

A. In so far, just looking at the income tax situation, since sales are one factor in producing the income, and all you are trying to measure is income, and you are unsure about the extent to which sales are a factor in producing income, the formula is an approximation for estimating where the geographical location of the income is.

Q. Sir, I didn't have an answer to the question. What's the effect of using the sales factor of apportionment formula? Doesn't that increase the burden of out-of-state producers and reduce the tax burden of in-state producers? Yes or no?

MR. HARNACK: Objection, Your Honor.

THE WITNESS: You can't answer that question directly.

MR. HARNACK: Objection, Your Honor. I think the witness is attempting to answer. He was interrupted. He may not be giving the answer that Mr. Gomoll wants, but he is answering the question.

THE COURT: He is trying to.

THE WITNESS: You have to answer that question in terms of compared to what. In answer to value-added tax I compared to what the value-added tax base would be in relationship to the sales factor. In the case of the income tax when you want to talk about increasing the burden on the out-of state manufacturer and decreasing the burden on the instate manufacturer, the burden of the income tax increasing as compared to what? You didn't describe what your standard was for increasing.

Q. **(BY MR. GOMOLL)** I think in regard to the value-added tax, you testified that the use of the sales factor increased the burden of the out-of-state producer, and decreased the burden of the instate producer.

A. I said as compared with what the burden would be, if you look at the value added as shown by the information that is available in the books, I have a comparison there. When you talk increase, it has to be increase with respect to something, its increase of the burden compared to what it would have been if you did not use a sales factor in trying geographically locate the value-added tax base.

Q. And the income tax situation, I think maybe what you are saying is if you had a two-factor formula of property and payroll, instead of three-factor formula with sales in it, would the burden increase for out-of-state producers as compared to a two-factor formula. And the answer would be yes. And would the burden decrease the income tax burden for an instate producer as compared to a two-factor formula? The answer would also be yes.

Now, is it unconstitutional to use the sales factor to achieve that result?

A. In this case you are talking about income and you are trying to locate the income, and in comparing the two formulas, both of them represent reasonable approximations of where the income is located. In the case of the value added taxation formula that has sales factor in it, does not geographically located value added in any reasonable way, given the nature of what a value added tax base is.

Q. Wasn't that the same criticism of the sales factor for apportioning income in the Willis report, that it wasn't a good factor to use in place of source of income?

MR. HARNACK: Objection, Your Honor. I have no objection to the State having two attorneys cross-examining Professor Oldman, but as I recall, Mr. Roesch asked precisely the same question about the Willis report.

THE COURT: Well, it's cross-examination. I certainly don't have total recall whether Mr. Roesch asked the same question. And it is examination. They can ask the same question 14 different ways in cross-examination.

Whether it's the same question or no, I don't know. Go ahead.

THE WITNESS: Do you want to repeat the question?

Q. **(BY MR. GOMOLL)** Wasn't that same criticism in the Willis report that the sales factor didn't reflect the source of income?

A. The Willis report, as I said before, did not reach that conclusion. The Willis report was attempting to reach a satisfactory solution in a situation in which one school of thought said that the sales factor should be one of the measures of the geographical location of income and another school said the other and the Willis committee had to come out with some approach to be uniform. Its initial conclusion was that either one would be perfectly all right as long as it was adopted uniformly. It then opted for the two-factor formula. Not because the sales factor is always bad, but because in the world of practical administration, it would save a lot of time, effort, and energy and assure a more even-handed operation of the income tax, and I think that's what I said before.

Q. On your direct examination, I think you testified what the single business taxes is the values added to the product. Now, what was the basis for that conclusion?

A. The value added tax, the Michigan single business tax, as it has been written in the statute, and as it has been described and summarized in the numerous articles that have written about it, describe it as a tax on the origin basis of value added, the place where the value is added. In cases of payroll and property, that's very easy

to identify. You know where that value is added, it's where these two factors of production are put to use. Therefore, there is relatively little discussion, almost no discussion in the literature about the Michigan tax, about the nature of, or the reason for, and the validity of the three-factor formula. It hasn't been analyzed. As far as I know, that's happening today for the first time.

Q. Is there anything in the single business tax itself to which you can point that would indicate that the Legislature intended to source component parts of the tax base?

A. The legislature intended to tax the value added in Michigan. And then it provided a formula subject to a number of exceptions, adjustments, and relief provisions as a way to determine the proportion of a multistate company's total value added which is to be assigned to Michigan.

Q. Is there anything in the act that you can point to that says compensation shall be attributed to the state where compensation is paid?

A. In so far as the act deals with compensation as an add on, and a specific item included in the value added tax base by implication, then the question is, where does it get included. Well, the place where the compensation is put to use, where the workers are earning the compensation, and it's so clear it seems to me that when compensation is added to the Federal income tax starting point, and that the tax is on Michigan value added, it's so clear that the place where the compensation is paid for the work done there is the place where it's added. It would

be redundant to add any more. To me the statute says that.

Q. Well, Section 45 of the single business tax says all of the tax base shall be apportioned to this state. Then by the use of the three-factor formula, it says all of the tax base. It doesn't indicate that the Legislature wanted to source component parts of the tax base, does it?

A. I think what it said there is that all of the tax base will be apportioned in accord with Section 69 and Section 69 is a complex of provisions starting off with the three factor formula.

Q. No, it doesn't say that. It says – let me read it. All of the tax base other than the tax base derived principally from transportation, financial or insurance carrier services or specifically allocated shall be apportioned to this state by multiplying the tax base by a fraction of the numerator of which is the property factor plus the payroll factor, plus the sales factor and the denominator, which is three.

A. That's the beginning of Section 69, you really have o read the whole section.

Q. No, it's Section 45.

A. Okay. But section 69 has to be read along with it as a part of the same statute in order to give that meaning.

Q. Now, as I understand your position, the income components of the value-added tax base should be apportioned, but other components like compensation can be specifically allocated?

A. I said the income components can either be apportioned on the basis of the formula, or through the use of separate accounting and transfer pricing, which is the way the Federal Government does it, and the way the other countries do it, but income could also be apportioned by formula the way most states do it in the United States today. Either one is a reasonable way to do it, and has been accepted in the real world of state practice. The use of the formula, the three-factor formula in the world of international practice, has not been accepted and is vigorously contested as to whether or not it's an acceptable means in international law.

Q. When you do that, though, aren't you really imposing separate taxes? You have tax on apportioned income and a tax on allocated compensation, a tax on allocated interest. You are breaking up the tax base into these little parts.

A. You are not breaking it up any more than you are breaking it up among the states when you are dealing with a multi-state enterprise. You are supposed to break it up. There is no single ball of wax when you deal with an enterprise that is involved with more than one state, not to mention more than one country. The question is how many ways are you going to treat it, you can't cut up the tax base in a way that that contrasts with the actual facts the taxpayer brings to bear.

Q. Can you separately account for a value added tax base within the state, would that be possible?

A. Would it be possible, certainly.

Q. How would you go –

A. It already appears in the books of probably most of the 7,000 people, 7,000 taxpayers that you have talked about. Because they know where their compensation is paid. They have to file for unemployment insurance and other records which identify in which state their compensation is to be treated, so that geographical apportionment is already done with respect to payroll.

With respect to property, it's usually subject to property taxes somewhere and most property is subject to tax in only one place unless it moves around, then it might be apportioned among the places where it is located. So that information is routine with respect to the major components of value added. The only one, as I have said several times today, that causes any trouble is income. And for the same reasons that we have hundreds of cases in the states, and in the Supreme Court dealing with the limits, the constitutional limits of when and how a state can choose how to apportion income, it is a particularly complex area of its own where there is a wide range of acceptable approaches to geographically locating the income component of value added, just as there would be for locating income as a tax base when it's the only tax base.

I am not quarreling with using formulas for the income components. In this particular case, as the stipulation of facts indicate, we are mostly dealing with years in which there is no income. So you don't have to worry about the use of apportionment formula at all if there is no income.

Q. Well, couldn't we determine a Michigan income for Caterpillar by taking its sales and subtracting Michigan expenses?

A. I doubt that you would be able to do that. But you could put it differently. I will withdraw that answer and say that if you have separate accounts that identified income, kept according to the recognized methods of keeping separate accounts, you would have a geographical set of separate accounts for which you could apply the tax on that basis. You would also have to make that available, of course, to the taxpayers. You couldn't do just simply that, but you could do that as part of an income tax, but then you must apply the income tax to everybody else too. If you want to do it with respect to only the income components of the value-added tax as a part of the value added tax, it also must be part of a statutory structure that permits that to be available for all taxpayers.

Q. Even with an income concept, you do admit there are component parts of an income tax base; isn't that correct?

A. Well, income is made up of a lot of additions or subtractions. It sets each item in the accounts as a component.

Q. So value added is made up of component parts, income is made up of component parts?

A. Right.

Q. So I suppose we could determine the income components from Caterpillar in Michigan by taking its Michigan sales and subtracting its Michigan expenses?

A. It's not quite as simply as that, because you have to look at a composite of internal transactions within Caterpillar to see which parts of its expenses are properly attributable to the sales in Michigan. You don't look just at the expenses in Michigan. You look at the expenses that belong to the receipts in Michigan. So —

Q. Isn't that somewhat inconsistent, though? You say on value added you just want to look at the Michigan components, but then on income you don't want to look at just the Michigan expenses?

A. You are not dealing with expenses in value added. You are looking at the value added as the base and it can only be added in one place. It's either in Michigan or out of Michigan. It can't be in both. And if the work is done out of Michigan, it's out-of-state compensation. The fact that that expense is part of a computation for income is a different question, and the income component is another question, and how you divide up the income component is the complex question. But it's not an important question, really, in this case, because we are not dealing with much income.

Q. Well, they had 93 million dollars of sales in Michigan.

A. Right. But there were 93 million dollars of sales as part of an overall activity which was conducted at a loss.

Q. But very little.

A. Except in one year, as I recall.

Q. And I think very little expenses in Michigan. Wouldn't that indicate that their Michigan activities are generating a lot of income?

A. That's not – it does not take into account the cost of the goods sold that are sold in Michigan, and the costs of the goods sold incurred outside of Michigan where the goods are produced. And so that if you are looking at the income element, you have to look at the income in terms of the income components of value added. And to do that you have to look at the company's entire accounts. If you are going to use the apportionment approach, if you want to use geographical separate accounting for income, then you have to reconstruct all of Caterpillar's accounts on a state-by-state basis.

Q. That seems somewhat inconsistent when you're saying our Legislature can't look at this value added concept as one ball of wax, you have to break it up into component parts. But now you are saying we can't break up the income on just Michigan receipts and Michigan expenses. We have to look at some place else.

A. You have to look at all of the components of the income. If you're taxing income, then you have to allow for multi-state taxpayers, the same definition of income as you are going to use for instate taxpayers and that will require the deduction of cost of goods sold.

Q. Professor Oldman, have you reviewed the returns filed by Caterpillar?

A. I have only looked at one of the Michigan value added tax returns, I have looked at one page.

Q. Have you looked at the apportionment formula?

A. I don't recall whether that was on that page or the next page or not. Presumably it was there. I only looked at that rapidly.

Q. Did you have any reason to believe that the property factor – would you believe that the property factor accurately reflects that extent of property in Michigan?

A. I have no reason to doubt it.

Q. And that the payroll factor accurately reflects the extent of payroll in Michigan?

A. Yes.

Q. And sales factor accurately reflects the extent of sales in Michigan?

A. Yes.

Q. So you have no problem with –

A. With those numbers?

Q. – with those numbers?

A. The problem is the use to which the sales factor number is put.

Q. Mr. Oldman, in your opinion, since Caterpillar has had no income and has losses, which you say should be apportioned, then you want to separately account for its payroll, which may well end up for a loss in this case, when we have so little Michigan payroll. So I think there is – do you understand my question? You have a large –

A. I think I understand. You would apportion losses just as you would apportion income.

Q. Right. And then apportioned that loss is greater than the Michigan compensation. So you end up with no tax base.

A. Because of the use of the sales factor, you might get yourself into the strange position of apportioning a loss to Michigan, which is greater than the amount of its actual payroll. And if you had carryovers of tax base allowed under the value added tax, then Caterpillar should be applying for a refund. Without carrying over each year. you can't have any less than zero tax base, so you don't have that problem.

Q. So we have a possibility of a negative tax base and the taxes imposed on the privilege of doing business. The taxpayers and Caterpillar have 60 to 90 million dollars sales in Michigan. So under your opinion, Caterpillar would pay no tax for the privilege of doing business?

A. It would happen in that situation. And that's the way the tax is basically designed, that if the net result of a given company's activity is not to have value added, but to actually consume value during the year. Now, it could be for the purpose of developing its future, maintaining relations with customers. It had a bad year, those things happen with companies, and therefore in that year, its tax base is so low that there is no tax at all that's due. There is no provision, as I understand in the Michigan VAT, SBT, for offsetting what would be a negative tax base in a given year, and it could arise with respect to multi-state taxpayers because of the way your factors are. It's something like the situation that I described earlier, when I said that some of the 7,000 taxpayers who don't sell in Michigan might end up with a tax that's much lower.

In some cases it might turn out that even if they sell in Michigan, the tax might be much lower because they had a loss instead of a profit, and for taxpayer who have losses nationwide, then the sales factor reduces that Michigan tax liability because they are now apportioning more of the loss, in a sense, to Michigan.

Q. I think we had one question, the excess compensation deduction. You testified that it was put in at the request of Michigan businesses that saw they had too much labor and would be wanting a break. Now, wouldn't that deduction also apply to multi-state taxpayers, to taxpayers like Caterpillar, as well?

A. So far as I know that works both ways, yes.

MR. GOMOLL: I have no further questions.

MR. HARNCK: I have no redirect.

THE COURT: You are excused. Your next witness?

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CLERK

No. 89-1106

In The

Supreme Court of the United States

October Term, 1989

TRINOVA CORPORATION,

Petitioner,

v.

STATE OF MICHIGAN,

Respondent.

On Writ Of Certiorari
To The Supreme Court Of Michigan

BRIEF OF ALCAN ALUMINUM CORPORATION, ET AL. AS AMICUS CURIAE IN SUPPORT OF PETITIONER

PATRICK R. VAN TIFLIN
(Counsel of Record)
MYRA L. WILLIS
JAMES H. GEARY
HOWARD & HOWARD ATTORNEYS, P.C.
Phoenix Building, Suite 500
222 Washington Square, North
Lansing, Michigan 48933
(517) 485-1483
Attorneys for Alcan Aluminum Corporation, et al.

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LIST OF AMICI CURIAE

ALCAN ALUMINUM CORPORATION,
ALLEGHENY LUDLUM CORPORATION,
ALUMINUM COMPANY OF AMERICA,
ARMOUR AND COMPANY,
ARVIN INDUSTRIES, INC.,
ASHLAND OIL, INC.,
BP OIL INC.,
BEATRICE COMPANY,
BECTON DICKINSON AND COMPANY,
THE BOC GROUP, INC.,
BLUE BELL, INC.,
BROCKWAY, INC.,
BURLINGTON INDUSTRIES, INC.,
CARLISLE CORPORATION,
CASTLE & COOKE, INC.,
CENTRAL SOYA COMPANY, INC.,
C. H. MASLAND & SONS,
THE COCA-COLA COMPANY,
COLGATE-PALMOLIVE COMPANY,
COLT INDUSTRIES OPERATING COMPANY,
CONSOLIDATION COAL COMPANY,
CONTROL DATA CORPORATION,
CRUCIBLE MATERIALS CORPORATION,
CUMMINS ENGINE COMPANY,
DATA GENERAL CORPORATION,
DEARBORN CHEMICAL COMPANY,
DIAL CORPORATION,
DIGITAL EQUIPMENT CORPORATION,
DONALDSON COMPANY, INC.,
THE DURIRON COMPANY, INC.,
E. I. DU PONT DE NEMOURS & CO.,
ELI LILLY AND COMPANY,
E. R. SQUIBB & SONS, INC.,
THE FIRESTONE TIRE & RUBBER COMPANY,
FIRST WISCONSIN FINANCIAL CORPORATION,
FISCHBACH AND MOORE, INC.,
FLEETGUARD, INC.,
FMC CORPORATION,

LIST OF AMICI CURIAE (Continued)

FOAMEX PRODUCTS, INC.,
GENERAL FELT INDUSTRIES, INC.,
GEO. A. HORMEL & CO.,
GRACE PETROLEUM CORPORATION,
HAMMERMILL PAPER COMPANY,
HONEYWELL INC.,
HONEYWELL INFORMATION SYSTEMS, INC.,
HOUSEHOLD MANUFACTURING, INC.,
HOUSEHOLD MERCHANDISE, INC.,
ICI AMERICAS, INC.,
INTERNATIONAL BUSINESS MACHINES CORPORATION,
INTERNATIONAL PAPER COMPANY,
JOY MANUFACTURING COMPANY,
KITCHENS OF SARA LEE, INC.,
LYNCHBURG FOUNDRY COMPANY,
MAGIC CHEF, INC.,
McDONALD'S CORPORATION,
MIDWAY AIRLINES, INC.,
MINNESOTA MINING AND MANUFACTURING COMPANY,
MOBAY CORPORATION,
MOORE BUSINESS FORMS, INC.,
NORANDEX INC.,
NORTHERN TELECOM INC.,
OLIN CORPORATION,
PRESTO PRODUCTS, INCORPORATED,
PRIMERICA CORPORATION,
RCA CORPORATION,
R. J. REYNOLDS TOBACCO COMPANY,
SARA LEE CORPORATION,
SCOTFOAM CORPORATION,
SHELLER-GLOBE CORPORATION,
SQUARE D COMPANY,
STANDARD PRODUCTS COMPANY,
STANDARD OIL CHEMICAL COMPANY,
SUN REFINING AND MARKETING COMPANY,
SUPPORT TERMINAL SERVICES, INC.,

LIST OF AMICI CURIAE (Continued)

TELEFLEX INCORPORATED,
THIOKOL CORPORATION,
TOYS "R" US,
UNION CARBIDE CORPORATION,
USS GREAT LAKES FLEET, INC.,
USX CORPORATION,
W. HEATH & COMPANY,
W. R. GRACE & CO.,
WM. WRIGLEY JR. COMPANY

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STATEMENT OF INTEREST

The procedural history of this case is a source of grave concern to Amici as multistate taxpayers transacting interstate business involving contact with the State of Michigan. The sequence of events which have transpired, beginning with the enactment of the Single Business Tax ("SBT") Act, the unanimous and final interpretation of § 69 of that Act by the courts of Michigan, the subsequent legislative amendment of § 69 alleged to have retroactive effect and the decision of the Michigan Supreme Court in this case call into question the fairness of the apportionment process under the SBT, the equality of treatment of multistate taxpayers domiciled within and without the State of Michigan and the tax consequences arising from interstate transactions concluding in Michigan.

Each Amici multistate taxpayer has an interest in the outcome of this case as either a Plaintiff in the Michigan Court of Claims seeking refunds of single business tax under § 69 of the Act or as a Petitioner in the Michigan Tax Tribunal seeking refunds of the tax or opposing assessment of additional single business tax where a request by certain Amici under § 69 of the Act has been denied by Respondent or as SBT refund claimants whose claims have not yet been ruled upon by the Respondent. Thus, Amici are situated similarly to the Petitioner in that in various administrative and judicial forums they seek the same type of relief under § 69 of the Act as was sought by Petitioner below.

The Michigan SBT Act was enacted as 1975 PA 228, MCL 208.1 *et seq.*; MSA 7.558(1) *et seq.* effective January 1, 1976 ("the Act"). The provision of the Act at issue in this case, § 69, was enacted in 1975 and remained unaltered until June 9, 1987 when 1987 PA 39 ("PA 39") was signed into law. Section 69 is Appendix Exhibit 1. 1987 PA 39 is Appendix Exhibit 11.

Section 69 of the Act was applied by the Michigan Tax Tribunal in *Jones & Laughlin Steel Corp v Michigan Dep't of Treasury* and *Wilson Foods Corp v Michigan Dep't of Treasury*, Docket Numbers 57892 and 57893 (September 5, 1984) ("*J & L*"). Appendix Exhibit 2. In *J & L*, the Tribunal decided that the factual test contained in § 69 of the Act, whether the apportionment provisions of the Act unfairly represented the extent of *J & L's* business activity in the state, had been met. The Tribunal determined the test was met based upon a showing that 50% more compensation paid by *J & L* in its business conducted everywhere was attributed to Michigan through the operation of the apportionment formula than J & L demonstrated was actually paid in Michigan. In a seven page opinion, the Michigan Court of Appeals affirmed the Tax Tribunal on September 3, 1985. 145 Mich App 405; 337 NW2d 397 (1985). Defendant applied for leave to appeal that decision to the Michigan Supreme Court and on March 18, 1986 the Court issued its Order denying the application for leave to appeal. 424 Mich 895; 384 NW 2d 8 (1986). Appendix Exhibit 3. On October 22, 1986, the Michigan Supreme Court denied reconsideration. 424 Mich 895; 384 NW 2d 8 (1986). Appendix Exhibit 4. Amici therefore understood the settled state of the law on this question to be that enunciated in the *J & L* decision of the Michigan Court of Appeals. Amici relied on this settled state of the law in filing their single business tax returns and/or refund claims arising from requests for apportionment formula relief under § 69.

In the meantime, the lower courts were consistently applying § 69 in granting apportionment formula relief to taxpayers who could demonstrate an unfair representation of their business activity. On June 11, 1986 Ingham County Circuit Chief Judge Michael G. Harrison granted judgment in favor of *Armco, Inc* in Docket No. 84-9612.

Appendix Exhibit 5. On January 24, 1987, Court of Claims Judge Stell granted judgment in favor of *Friendly Ice Cream Corp* in Docket No 86-10413-CM. Appendix Exhibit 6. On March 30, 1987, Court of Claims Judge (now Federal District Judge) Robert Holmes Bell authored a seven page *Opinion and Order of the Court* granting judgment to *MTD Products, Inc* in File No. 86-10416-CL applying § 69. Appendix Exhibit 7. On April 27, 1987 Chief Judge Michael G. Harrison granted judgment to *AMP Inc* in Docket No. 86-10216-CM. Appendix Exhibit 8. On May 5, 1987 Court of Claims Judge Robert Holmes Bell granted the judgment below for refund of SBT to *Trinova Corp* in Docket No. 86-10430-CM. Appendix Exhibit 9. On May 22, 1987 Court of Claims Judge Robert Holmes Bell granted judgment to *Penton/Industrial Publishing Co Inc* in Docket No. 86-10231-CM. Appendix Exhibit 10.

Then, PA 39 was signed into law on June 9, 1987. PA 39 amended § 69 of the Act. Appendix Exhibit 11. Respondent then sought to apply PA 39 retroactively to § 69 cases pending in the Court of Claims and involving tax years prior to 1987, alleging that PA 39 constituted a complete defense to the pending cases. However, on August 21, 1987 Court of Claims Judge Thomas L. Brown granted judgment in favor of *Consolidation Coal Co* for refund of SBT in Docket No. 82-8407. In *Consolidation Coal*, Judge Brown specifically considered PA 39 and found that it was not applicable to Plaintiff's preexisting SBT Refund Claim based upon *J & L*. Appendix Exhibit 12. On November 2, 1987 Court of Claims Judge Kallman denied Defendant's Motion for Summary Disposition of the SBT Refund Claim in *Digital Equipment Corp* in Docket No. 86-10484-CM. Judge Kallman rejected Respondent's claim that PA 39 was applicable to *Digital's* pre-existing SBT Refund Claim under § 69 of the Act. Appendix

Exhibit 13. On November 25, 1987 Court of Claims Judge Carolyn Stell granted judgment for refund of SBT to *First Wisconsin Financial Corp* in Docket No. 87-11132-CM. Judge Stell found Respondent's administrative effort to retroactively apply PA 39 to pre-existing SBT Refund Claims was not timely plead as an affirmative defense, but held in the alternative that retroactive application of PA 39 to pre-existing SBT Refund Claims for prior tax years would violate the U.S. Constitution's guarantee of due process and the commerce clause. In the alternative, Judge Stell also held that, factually, *First Wisconsin* had established that the apportionment provisions of the Act produced a grossly distorted result under PA 39 and granted judgment to *First Wisconsin* under § 69 as amended by PA 39. Appendix Exhibit 14.

On December 15, 1987 Court of Claims Judge James R. Giddings granted a judgment of refund of SBT to *Magic Chef, Inc* in Docket No. 86-10395-CM. Judge Giddings held that PA 39 was not retroactively applicable to Plaintiff's pre-existing SBT refund claims for the reason that PA 39 worked a substantive change to § 69 of the Act and that retroactive application would violate the Separation of Powers Clause of the Michigan Constitution. Appendix Exhibit 15. On December 17, 1987 Court of Claims Judge Stell granted judgment to *Sara Lee Corp* for refund of SBT in Docket No. 87-11143-CM for the same reason and on the same basis as in *First Wisconsin Financial Corp, supra*. Appendix Exhibit 16. On December 22, 1987 Court of Claims Judge James T. Kallman granted judgment in *Presto Products, Inc*, Court of Claims Docket No. 83-8827. (Appendix Exhibit 17) and also on December 23, 1987 to *Wm Wrigley Jr Co* in Docket No. 87-11013-CM. Appendix Exhibit 18. On December 23, 1987 Chief Judge Michael G. Harrison granted judgment for refund of SBT to *Blue Bell,*

Inc in Docket No. 86-10620-CM. Judge Harrison held that it was unnecessary to rule on retroactivity of PA 39 for the reason that Plaintiff sustained its burden of showing that the apportionment provisions of the Act when applied to Plaintiff's tax base for the years involved attribute activity to Plaintiff in Michigan which is out of all appropriate proportion to the actual business transacted in Michigan and led to a grossly distorted result. Appendix Exhibit 19. On January 4, 1988 Court of Claims Judge Stell granted judgment for refund of SBT under § 69 to *Sheller-Globe Corp* in Docket No. 87-11073-CM. Appendix Exhibit 20. On January 21, 1988 Court of Claims Judge Thomas L. Brown granted a SBT refund to *USX Corp* in Docket No. 86-10901-CM. Appendix Exhibit 21.

On February 22, 1988, a three judge panel of the Michigan Court of Appeals issued an opinion in *Trinova Corp v Michigan Dep't of Treasury*, 166 Mich App 656; 421 NW2d 258 (1988) ("Trinova") which was critical of the Court of Appeals' decision in *J & L*, rejecting the *J & L* holding and finding PA 39 was retroactively applicable to its appellate review of a Court of Claims judgment entered prior to the enactment of PA 39. In an accompanying order of the same date, the *Trinova* panel certified a conflict of the *Trinova* opinion with the *J & L* decision pursuant to Michigan Supreme Court Administrative Order 1984-2.

On February 23, 1988 Court of Claims Judge Carolyn Stell granted a § 69 SBT Refund Claim judgment in *Northern Telecom*, Inc Docket No. 86-10406-CM. After reviewing the Court of Appeals Decision in *Trinova*, Court of Claims Judge Stell found in the alternative that Northern Telecom had factually established the existence of a grossly distorted result under PA 39. Appendix Exhibit 22.

There followed the decision of the Michigan Supreme Court in *Trinova*, which this Court has agreed to review. In that decision, the Michigan Supreme Court rejected the *J & L* rule and found that the apportionment formula relief provision of § 69 was designed to function essentially as a constitutional circuit breaker; acknowledged that taxation of an intrastate activity by an interstate enterprise presents the potential for due process and commerce clause violations; found that § 69 allows the use of an alternate method of apportionment if the apportionment provisions result in the unconstitutional taxation of a unitary business, i.e., to tax the extraterritorial activity of the taxpayer and that the primary role of § 69 is to safeguard the Act and satisfy the basic constitutional foundation of fairness. Opinion, pages 156 and 157. The Court found that the single business tax apportionment process satisfied this Court's requirement that an apportionment formula be externally consistent and rejected proof that the apportionment formula had wrongly subjected to taxation the extraterritorial (to Michigan) activity of *Trinova*, relying upon the fact that the subject of the Act ("Business Activity") "thus encompasses the complete range of entrepreneurial activities of which compensating employees is but one part" (Opinion, page 161) and upon "the integrated nature of formulary apportionment which rejects separate accounting as a means to identify business activity by reference to a discrete geographic boundary" (Opinion, page 162).

ARGUMENT

A. OVERVIEW OF THE SINGLE BUSINESS TAX APPORTIONMENT PROCESS

The Act imposes a specific tax on the adjusted tax base of every person with business activity within the state. MCL 208.31(1); MSA 7.558(31)(1). The tax base consists of various components, including federal taxable income, compensation paid (payroll and fringe benefits), depreciation deducted, interest, royalties and dividends paid, plus other adjustments prescribed by § 9 of the Act. The principal federal tax deductions added back to federal taxable income in arriving at SBT base are compensation (wages and fringe benefits) paid to employees and depreciation. Appendix Exhibit 23. The SBT base, and the components of tax base, may be depicted as follows:

Taxable Business Activity (§ 31(4)) = Tax Base (§ 9) =

TAX BASE COMPONENTS
federal taxable income +
compensation paid +
depreciation deducted +
interest paid +
royalties paid +
other miscellaneous adjustments in § 9

Tax responsibility is thus defined in terms of business activity, which, in turn, is defined by the tax base components of federal taxable income plus most deductions taken in arriving at federal taxable income.

When a taxpayer engages in business activity both inside and outside the state of Michigan, the statute requires an apportionment of the tax base. MCLA 208.41; MSA 7.558(41). A three-factor apportionment formula is used to apportion the tax base. The formula makes a comparison of sales made, property used and payroll

(wages and salaries) paid in Michigan to sales made, property used and payroll paid by the taxpayer everywhere. MCL 208.45; MSA 7.558(45). The apportionment formula may be depicted in the following fashion:

$$\frac{\frac{\text{Michigan Property}}{\text{Total Property}} + \frac{\text{Michigan Payroll}}{\text{Total Payroll}} + \frac{\text{Michigan Sales}}{\text{Total Sales}}}{3} = \text{Average Apportionment Percentage}$$

The formula produces an average apportionment percentage by which the tax base is multiplied, resulting in an approximation of that portion of the business activity, defined in terms of tax base, attributable to Michigan. Adjustments are allowed for certain capital expenditures which are not relevant to the present controversy. The tax rate is then applied to this apportioned, adjusted tax base to determine tax liability. This process is depicted in Exhibit 24.

The SBT apportionment formula is utilized by multistate businesses to approximate taxable business activity within Michigan. However, formulary apportionment may not accurately reflect the level of the taxpayer's activity within the state. Accordingly, the SBT Act contains a relief provision found in § 69. Appendix Exhibit 1. Section 69 provides in relevant part, that "If the apportionment provisions of this Act do not fairly represent the extent of a taxpayer's business activity in this state, the taxpayer may petition for or the commissioner may require, in respect to all *or any part of* the taxpayer's business activity if reasonable: . . . (d) the employment of any other method to effectuate an equitable *allocation and apportionment* of the taxpayer's tax base". (Emphasis added)

In *J & L, supra,* the Michigan Court of Appeals granted the taxpayer § 69 relief from the apportionment provisions of the Act based on the fact that the apportionment provisions unfairly represented the taxpayer's business activity in the state. This unfair representation of business activity was evidenced in the overstatement of the compensation component of tax base, which was the major component (85%-100%) of the tax base being apportioned. The Court held that an apportionment of the compensation component of tax base that was more than fifty percent greater than the actual compensation paid in Michigan was an unfair representation of the taxpayer's business activity in the state. The relief granted in *J & L, supra,* was to allow apportionment of all of the tax base, excluding the compensation component, by the use of the average apportionment percentage, and to add to this apportioned tax base the amount of compensation actually paid in Michigan. The relief granted was a combination of *allocation* of compensation *and apportionment* of remaining tax base to effectuate an equitable attribution of the tax base of *J & L* to Michigan. This court will note that such a bifurcated method of attribution of business activity, utilizing *"allocation and apportionment,"* is specifically contemplated by subsection (d) of § 69. The relief authorized by § 69 may also, by specific authorization of the statute, be granted "in respect to all or *any part* of the taxpayer's business activity". The *J & L* Court was thus operating on solid statutory underpinning in affirming the Tribunal award of § 69 relief.

B. FEDERAL CONSTITUTIONAL REQUIREMENTS FOR THE VALIDITY OF STATE TAX APPORTIONMENT

An apportionment formula relief provision like § 69 is most easily understood against the background of federal constitutional principles concerning the scope and extent of the taxing power of the states. This section of the brief will therefore outline the requirements of the federal constitution as interpreted by this Court to which a state tax apportionment formula must conform.

The Due Process Clause of the 14th Amendment of the U.S. Constitution, US Const, Am XIV, and the Commerce Clause (US Const, Art I, § 8 cl 3) have been interpreted to prohibit a state from taxing "values outside its borders." *Container Corp of America v Franchise Tax Board*, 463 US 159; 103 S Ct 2933; 77 L Ed 2d 545, *reh den*, 464 US 909; 104 S Ct 265 (1983), quoting *ASARCO, Inc v Idaho State Tax Comm'n*, 458 US 307; 102 S Ct 3103; 73 L Ed 2d 787, *reh den*, 459 US 961 (1982). In order to determine what "values" are properly attributable to a given state, this Court has upheld the constitutionality of the use of formulary apportionment methods. *Northwestern States Portland Cement Co v Minnesota*, 358 US 450; 79 S Ct 357; 3 L Ed 2d 421 (1959); *Underwood Typewriter Co v Chamberlain*, 254 US 113; 41 S Ct 45; 65 L Ed 165 (1920). The Due Process Clause (14th Amendment, § 1) and Commerce Clause (Art. I, § 10) of the United States Constitution have both been interpreted by this Court as restricting a state's ability to tax a corporation conducting business activities within and without the taxing state. The Due Process Clause considers the fairness of a state's tax statute by determining whether it results in "extraterritorial values being taxed". *Butler Brothers v McColgan*, 315 US 501, 507; 62 S Ct 701; 86 L Ed 991 (1942). The

Commerce Clause has a broader reach, embracing the Due Process requirement of fairness as well as prohibiting discrimination against interstate commerce. In order to satisfy the Commerce Clause, a state tax on multistate business activities must (i) be applied to an activity with a substantial nexus with the taxing state, (ii) be fairly apportioned (iii) not discriminate against interstate commerce, and (iv) be fairly related to the services provided by the state. *Complete Auto Transit, Inc. v Brady*, 430 US 274; 97 S Ct 1097; 51 L Ed 2d 326 (1977).

Formulary apportionment methods have generally been found to fulfill both the Due Process and Commerce Clause requirements; *Butler Brothers, supra*, (three-factor formula); *Underwood Typewriter Company v Chamberlain, supra*, (single-factor formula); *Moorman Manufacturing Company v Bair*, 437 US 267; 98 S Ct 2340; 57 L Ed 197 (1978)(single-factor formula). However, formulary apportionment has also been recognized as less than precise, achieving only an approximation of a taxpayer's business activity in a particular state. *Moorman Manufacturing Company, supra*. This broad concept thus does not hold that formulary apportionment is per se constitutional and the impact of a state's apportionment method on a *particular taxpayer* must still satisfy the Due Process and Commerce Clauses.

The U.S. Constitution requires that the tax base subject to tax in any state must bear a reasonable relationship to the business activity conducted by the taxpayer within the taxing state. For a formularly apportioned tax to withstand constitutional scrutiny, the 14th Amendment Due Process Clause requires a rational relationship between the tax base attributed to a state and the intrastate values of the enterprise being taxed. *Mobil Oil Corp v Comm'r of Taxes*, 445 US 425, 436-437; 100 S Ct 1223; 63 L

Ed 2d 510 (1980). *Exxon Corp v Wisconsin Dep't of Revenue*, 447 US 207; 100 S Ct 2109; 65 L Ed 2d 66 (1980); *Moorman Mfg Co v Bair, supra*. In analyzing whether such a relationship exists, this Court has stated an apportionment formula must be "fair". *Exxon, supra* at 219. See also, *Moorman, supra*.

In deciding cases involving the validity and legitimacy of state tax apportionment processes, this Court has rejected the notion that judicial scrutiny of the process begins and ends with merely a reference to the label under which the taxing system parades. The leading case on the Commerce Clause in state tax cases is *Complete Auto Transit, Inc., v. Brady, supra*. Therein, this Court stated:

> There is no economic consequence that follows necessarily from the use of the particular words, "privilege of doing business" and a focus on that formalism merely obscures the question whether the tax produces a forbidden effect. 430 U.S. at 288.

In *American Trucking Ass'ns, Inc. v. Scheiner*, 483 US 266, 107 S Ct 2829; 97 L Ed 2d 226 (1987), this Court said:

> In our more recent decisions we have rejected the somewhat metaphysical approach to the Commerce Clause that focused primarily on the character of the privilege rather than the practical consequences of the tax. In 1977, while we recognized that we had invalidated privilege taxes on in-state activity deemed to be part of interstate commerce, we also noted that we had "moved toward a standard of permissibility of state taxation based upon its actual effect rather than its legal terminology." 107 S.Ct. at 2846 [Citations and footnotes omitted.]

And further:

> The way in which a tax levied on participants in interstate commerce is *measured and assessed* bears directly on whether it implicates central Commerce Clause values. 107 S.Ct. at 2839 [Emphasis added].

Thus, as shown in A. of this Brief, and as amplified by Appendix Exhibit 23, this Court must ascertain the validity of the single business tax apportionment process by reference to the way in which the single business tax liability of a multistate taxpayer is measured and not end its inquiry at the doorstep of the label which the Michigan legislature and the Michigan Supreme Court have placed upon the single business tax. A tax on "business activity" measured principally by compensation and depreciation expense is a tax on compensation and depreciation.

In its 1983 opinion in *Container, supra*, this Court discussed the two tests of apportionment formula fairness: internal consistency and external consistency. To be internally consistent, a formula must be such that, if applied by every jurisdiction, it would result in no more than all of a taxpayer's business income (or other tax base) being taxed. External consistency requires that the factor(s) used in the apportionment formula must accurately reflect a reasonable sense of how the income (tax base) to be apportioned is generated. 463 US at 169.

This court has recognized that the three-factor apportionment formula is "necessarily imperfect," *Container, supra*, at 183, n 20, yet has upheld various methods as "fair." The three-factor formula was approved in *Butler Bros v McColgan, supra*. However, in *Container*, this court stated, at 170:

> The Constitution does not "invalidat[e] an apportionment formula whenever it *may* result in taxation of some income that did not have its source in the taxing State. . . ." Moorman Mfg. Co., supra, at 272, 98 S Ct 2340, 57 L Ed 2d 197 (emphasis added). See Underwood Typewriter Co., 254 US, at 120-121, 65 L Ed 165, 41 S Ct 45.

> Nevertheless, we will strike down the application of an apportionment formula if the taxpayer can prove "by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportion to the business transacted . . . in that state,' [Hans Rees' Sons, Inc.], 283 US at 135 [51 S Ct 385, 75 L Ed 879] or has 'led to a grossly distorted result,' [Norfolk & Western R. Co. v State Tax Comm'n, 390 US 317, 326 [88 S Ct 996, 19 L Ed 2d 1201](1968)]." Moorman Mfg. Co., supra, at 274, 57 L Ed 2d 197, 98 S Ct 2340.

The context of the *Container* opinion was the apportionment of an income base since that was the measure of the tax. However, the general principle which may be drawn from *Container* is that if the tax base attributed to the taxing state by the apportionment formula is out of all appropriate proportion to the business transacted in that state or the apportionment process leads to a grossly distorted result, application of the apportionment formula will fail under the United States Constitution. A formulary apportionment method which attributes an amount of tax base "out of all appropriate proportion" to the business transacted within the state is prohibited. Such a method lacks the mandated rational relationship between tax base attributed to the state and the intrastate values of the enterprise. Such distortion may result due to a lack of rational relationship between the tax base components being apportioned and the factors of the apportionment formula by which the tax base is apportioned. Absence of this rational relationship runs afoul of the requirements of the Due Process and Commerce Clauses of the Constitution. *Hans Rees' Sons, Inc v North Carolina ex rel Maxwell*, 283 US 123; 51 S Ct 385; 75 L Ed 879 (1930). In this case, the Court found the statutory apportionment formula as

applied to the taxpayer's business for the years in question, " . . . operated unreasonably and arbitrarily, in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the appellant [taxpayer] in that state . . . " (283 US at 135) based on evidence presented by the taxpayer showing that approximately 17% of its income had its source in North Carolina rather than the 66% to 85% apportioned to North Carolina. The Court based its holding on the following ruling:

> When, as in this case, there are different taxing jurisdictions, each competent to lay a tax with respect to what lies within, and is done within, its own borders, and the question is necessarily one of apportionment, evidence may *always* be received which tends to show that a state has applied a method, which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to the transactions within its jurisdiction. 283 US at 134 [Emphasis added].

In *Norfolk & Western R Co v State Tax Comm'n*, 390 US 317; 88 S Ct 995; 19 L Ed 2d 1201 (1968), the Missouri tax apportioned the value of all of the taxpayer's rolling stock among Missouri and other states based on a mileage formula (i.e., miles traveled by all of taxpayer's rolling stock in Missouri relative to miles traveled by taxpayer's rolling stock everywhere). The taxpayer presented evidence showing that the mileage formula yielded a grossly distorted result because some of its rolling stock was used permanently in Missouri whereas much of the rest of the rolling stock was never used in Missouri. In its finding that the tax assessment at issue violated the Due Process and Commerce Clauses, this Court observed:

> Any formula used must bear a rational relationship, both on its face and in its application, to property values connected with the taxing State. 390 US at 325.

The Court explained that an apportionment formula cannot necessarily be universally applied to all taxpayers without violating constitutional protections because:

> The facts of life do not neatly lend themselves to the niceties of constitutionalism; but neither does the Constitution tolerate any result, however distorted, just because it is the product of a convenient mathematical formula which, in most situations, may produce a tolerable product. 390 US at 327.

The *Norfolk and Western* decision applied the *Hans Rees'* rule as follows:

> We repeat that it is not necessary that a State demonstrate that its use of the mileage formula has resulted in an exact measure of value. But when a taxpayer comes forward with strong evidence tending to prove that the mileage formula will yield a grossly distorted result in its particular case, *the State is obliged to counter that evidence or to make accommodations* necessary to assure that its taxing power is confined to its constitutional limits. If it fails to do so and if the record shows that the taxpayer has sustained the burden of proof to show that the tax is so excessive as to burden interstate commerce, the taxpayer must prevail. 390 US at 329 [Emphasis added].

The Court also said:

> On the other hand, the Court has insisted for many years that a State is not entitled to tax tangible or intangible property that is unconnected with the State . . . The taxation of property not located in the taxing State is constitutionally invalid, both because it imposes an illegitimate restraint on interstate commerce and because it denies to the taxpayer the process that is his due. A State will not be permitted, under the shelter of an imprecise allocation formula or by ignoring the peculiarities of a given enterprise, to 'project the taxing power of the state plainly beyond its borders . . . 'Any formula used must bear a rational relationship, both on its face and in its application, to property values connected with the taxing State. 390 US, at 325.

The *Hans Rees* case thus teaches us that a state agency reviewing a challenge brought by a multistate taxpayer to the fairness of the apportionment process must necessarily engage in a review of evidence offered by the taxpayer that the apportionment process, even if fair on its face, has captured tax base which is in no sense attributable to the activity within the taxing jurisdiction. *Norfolk* adds to that teaching by instructing that the State must come forward with evidence that its taxing power has not extended beyond the borders of the taxing state. *Norfolk* further instructs us that the State must make accommodations necessary to insure confinement of the taxing power to constitutional limits. As originally enacted, § 69 provided such an accommodation. However, as interpreted and applied by the Michigan Supreme Court in *Trinova*, amended § 69 does not provide the accommodation necessary to assure taxing power confinement as required by *Norfolk*.

The decisions of this Court allow state taxing processes to look to the activity of a multistate taxpayer as a whole where necessary to ascertain the extent and value of the activity occurring within the taxing state. This Court has made it clear, however, that such a multistate perspective is not intended to allow the taxing state to reach and subject to taxation those activities which occur outside the state. In *Wallace v Hines*, 253 US 66; 40 S Ct 435; 64 L Ed 782 (1920), this Court said:

> The only reason for allowing a State to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it, when they are part

> of an organic system of wide extent, that gives them a value above what they otherwise would possess. The purpose is not to expose the heel of the system to a mortal dart – not, in other words, to open to taxation what is not within the State.

To sum these constitutional requirements before applying them to the case at bar, it is fair to conclude that although this Court recognizes formulary apportionment is imprecise and yields only an approximation of taxable activity within a taxing state, formulary apportionment generally meets Due Process and Commerce Clause requirements as long as the result is not the taxing of values outside the borders of the taxing state and the apportionment process is fair and not discriminatory. The tax base subject to tax must bear a reasonable relationship to the business activity conducted by the taxpayer within the taxing state and the guarantee of fairness in the process of apportionment is assured, at least in part, by requiring that the factors used in the apportionment formula accurately reflect a reasonable sense of how the tax base to be apportioned (whether income or value added) is generated. Finally, this Court has emphasized that the determination of constitutional acceptability of formulary apportionment is not made by reference to the formal language of the tax statute and the label under which it operates but rather its practical effect and consequences on the taxpayer.

Turning now to an application of these principles to the case at bar, it is clear that the Michigan Single Business Tax apportionment formula fails to meet the constitutional requirements for fairness in the apportionment process in this case. The tax base of Trinova consisted exclusively of compensation expense and depreciation expense in 1980. These expenses are of such a nature that

they can be geographically sourced to locations other than Michigan and are also of such a nature that they can be precisely calculated. In such an instance, it is difficult to imagine why apportionment should even be considered.

Compounding the problem is the fact that the apportionment formula requires these expenses to be imprecisely approximated and attributed to Michigan by reference to the Petitioner's property, payroll and sales factors despite the fact that sales in Michigan bear no rational relationship to the incurral of compensation expense or depreciation expense which is all that is being taxed (the tax base) in 1980. In such an instance, the foregoing constitutional principles render the tax base apportionment attempted in this situation invalid.

The problem in this case arises from the selection of the three factor apportionment formula as the mechanism for attribution of the single business tax base of a multistate taxpayer to Michigan. Except for the payroll factor (which correlates directly to the compensation component of tax base) and to a lesser extent the property factor (which correlates less precisely to the depreciation component of tax base), the three factor apportionment formula does not reflect a reasonable sense of the way in which the tax base of Trinova and Amici is generated in the taxing state. In the instance of Trinova and Amici, the formula is simply unfair in its application. The reasons for which this unfairness arises can be traced to the genesis of the formula.

The source of the three-factor apportionment formula utilized in the SBT Act is the Uniform Division of Income for Tax Purposes Act (UDITPA) drafted by the National Conference of Commissioners on Uniform State Laws and approved by the House of Delegates of the American Bar

Association in 1957. Its purpose and design was to prescribe a uniform method by which the *income* of a multistate taxpayer could be apportioned to the various states. Indeed the prefatory note to UDITPA says: "The Uniform Division of Income for Tax Purposes Act is designed for enactment in those states which levy taxes on or measured by net income". Appendix Exhibit 25.

UDITPA was adopted in Michigan as a portion of the Multi-State Tax Compact Act, 1969 PA 343; MCL 205.581 *et seq;* MSA 4.146(101) *et seq.* UDITPA § 18 is virtually identical to § 69 of the Act as originally enacted. Appendix Exhibits 1 and 26. The editorial comment to UDITPA § 18 contemplated, more than thirty years ago, exactly the type of relief granted by the Tax Tribunal and approved by the Courts in *J & L.* The comment provides, in part, "The phrases in § 18(d) do not foreclose the use of one method for some business activity and a different method for a different business activity". Thus, it was entirely within the purview of § 69(d) that compensation and depreciation in SBT base could be allocated and the remainder of the tax base components could be *apportioned* under a relief provision such as UDITPA § 18 and § 69 of the Act.

Professor William J. Pierce of the University of Michigan Law School authored an article entitled *The Uniform Division of Income for Tax Purposes Act*, 35 TAXES 747 (1957). At page 747, Professor Pierce wrote:

> The Uniform Act deals with the allocation and apportionment of *income* of multistate businesses and is designed for enactment in those states which have either net income taxes or taxes measured by net income . . . .

At page 781, Professor Pierce concludes:

> Section 18 [of UDITPA, which is § 69 of the SBT Act] is a general section which permits the tax

> administrator to require or the taxpayer to petition for some other method of allocating and apportioning the income where unreasonable results ensue from the operation of the other provisions of the Act. *This section necessarily must be used where the statute reaches arbitrary or unreasonable results so that its application could be attacked successfully on constitutional grounds.* Furthermore, it gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle the constitutional problem as well as the unusual cases, because *no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.* (Bracketed material and emphasis added)

Thus, the authors of the three-factor apportionment formula recognized at the outset the observation of this Court that formulary apportionment is necessarily imprecise and imperfect and suggested that a relief mechanism must be built into any apportionment system. Nonetheless, apportionment of income remains the general rule due to the fact that it is practically impossible in most cases to precisely attribute to each state that amount of income earned in each state by a multistate taxpayer. As this Court said in *Container, supra:*

> Allocating income among various taxing jurisdictions bears some resemblance, as we have emphasized throughout this opinion, to slicing a shadow. 463 US at 192.

However, the SBT is not a tax upon income. MCL 208.31(4); MSA 7.558(31)(4) provides, "The tax so levied and imposed is upon the privilege of doing business and

not upon income." The tax base contains federal taxable income only as a starting point. MCL 208.9(1); MSA 7.558(9)(1). As to Trinova, the SBT operates to a predominant extent as a tax upon compensation paid and depreciation deducted. 105% of Trinova's tax base in 1980 consisted of compensation paid to its employees everywhere and 10.52% consisted of depreciation deducted with respect to property located everywhere. Stipulated Facts, 8.

Unlike the difficulty traditionally associated with determining the state by state sources of net income for a multistate taxpayer, the location of employees and assets, the payment of compensation, and the deduction of depreciation can usually be precisely determined and fairly allocated to a particular state.

The apportionment provisions of the Act, when applied to the most significant component of Trinova's tax base, compensation, resulted in an apportionment to Michigan of 3,868% more compensation than its actual Michigan compensation paid. Furthermore, the apportionment formula resulted in an apportionment to Michigan of 96,883% more depreciation than Trinova's depreciation deductions taken on property actually located in Michigan. Application of the apportionment provisions of the Act to Trinova's tax base thus results in taxation of values clearly reposing outside of the borders of Michigan. The distortions demonstrated by Trinova are "out of all appropriate proportion" to actual compensation paid and depreciation deducted for assets located within the state of Michigan by the taxpayer. *Norfolk, supra*. There is clearly no rational relationship between compensation and depreciation apportioned to the state and the amount of compensation and depreciation which Trinova has demonstrated it paid and deducted in

Michigan. Absence of this rational relationship runs afoul of the requirements of the Due Process and Commerce Clauses of the Constitution. Therefore, application of the apportionment formula to the compensation and depreciation components of Trinova's tax base is in violation of both the Due Process and Commerce Clauses of the U.S. Constitution.

In fact, the SBT apportionment formula, when applied to some taxpayers without mitigation under § 69, violates the external consistency requirement of *Container, supra*. External consistency, as one of the two components of fairness of an apportionment formula identified by the Court in *Container, supra*, requires that the factors used in the apportionment formula reflect a reasonable sense of how the tax base to be apportioned is generated. As applied to Trinova, the SBT apportionment formula lacks the requisite external consistency since the factors used to apportion the SBT base, (property, payroll and sales) do not reasonably reflect how that tax base is generated. As with Amici, most SBT taxpayers have a tax base which is comprised principally of compensation paid. Appendix Exhibit 23 indicates that the tax base of a typical SBT taxpayer consists principally of compensation paid (76.77%) with the balance being composed of depreciation, interest expense, business income (5.7%) and other adjustments to tax base in § 9 of the Act. This tax base, composed primarily of compensation paid, is apportioned to the state by the use of an apportionment formula comprised of the property, payroll and sales factors. Despite the fact that the sales factor of the statutory apportionment formula relates only to business income, a relatively insignificant portion of the tax base (5.7%), the sales factor is weighed equally (1/3) along with the other apportionment factors. The factors used to apportion the tax base thus do not reasonably relate to the components

of that tax base, as the apportionment formula does not properly weigh the factors so as to reflect the composition of the tax base. Absence of this relationship between the apportionment factors and the components of tax base indicates a lack of external consistency. The distortive operation of the SBT apportionment formula on Trinova and Amici is thus in violation of the Due Process and Commerce Clauses of the U.S. Constitution.

However, this constitutional issue need not be reached by this Court if Trinova is allowed to show by credible evidence that it is entitled to relief under § 69 of the Act for the reason that apportionment of the compensation and depreciation components of its tax base results in an unfair representation of its business activity within Michigan. The remedy to an unconstitutional reach of the SBT to out of state compensation and depreciation is provided by the Act itself. Section 69 provides the test is whether the apportionment provisions of the Act do not "fairly represent" the extent of a taxpayer's business activity. If so, a modification of the apportionment method is allowed, including a combination of apportionment *and allocation*.

In *Twentieth Century Fox Film Corp v Dep't of Revenue*, 299 Or 220; 700 P2d 1035, 1039-40 (1985), the Supreme Court of Oregon ruled that its statutory equivalent to § 18 of UDITPA was to be applied to remedy situations where the apportionment formula does not fairly represent the business activity of a taxpayer. The Court held that the relief provisions of UDITPA were applicable in two situations: (1) To remedy unconstitutional results; or (2) To provide alternatives to statutory apportionment in cases where the UDITPA formula does not fairly represent the business activity of the taxpayer. *Id.* at 228. *Twentieth Century Fox* illustrates the employment of § 69-type relief

to avoid the necessity of a ruling by this Court on whether the SBT apportionment provisions unconstitutionally tax a multistate taxpayer. The Michigan Supreme Court below, although incorrect in its conclusion that *Trinova* was not subjected to unfair apportionment and discrimination, at least admitted that § 69 was enacted to protect against an unconstitutional application of the apportionment provisions of the Act. This Court should enunciate guidelines to be followed by the Michigan Courts in exercising the power granted by § 69 so that it is allowed to operate to such end.

C. THE *J & L* INTERPRETATION OF § 69 OF THE ACT WAS CONSTITUTIONALLY CORRECT AND CONSISTENT WITH THE DECISIONS OF THIS COURT

Following enactment of the SBT Act in 1976, the Michigan Court of Appeals was faced with interpreting the meaning of "fairly represent the extent of the taxpayer's business activity" for purposes of § 69 of the new Act. What constituted "fairness" for purposes of this section was the sole issue before the court in *J & L, supra*. The Court noted that:

> Respondent contends that fairness is tested by weighing the reasonableness of the taxpayer's final tax liability against the level of its business activity within the state, citing *Armco Steel Corp v Dep't of Revenue*, 359 Mich 430; 102 NW2d 552 (1960) . . . The problem with respondent's proposed test is that it does not focus on the fairness of the *apportionment* provisions of the Act for which § 69 is designed to provide relief. We believe instead that the proper test for invoking § 69 relief is whether the taxpayer's Michigan tax base, as derived from the application of the three-factor apportionment formula to its adjusted tax base, accurately reflects the extent of

the taxpayer's business activity within the state. (Emphasis added) 145 Mich App at 409.

Noting that § 69 of the Act and a prior tax statute were, for pertinent purposes, identical to one another, the court looked to the interpretations of the prior law in determining what is meant by the statement that "the apportionment provisions . . . do not fairly represent the extent of the taxpayer's business activity in this state." 145 Mich App at 410. The Court emphasized that, "The inquiry does not turn on the end result, i.e., tax liability. Rather, it turns on whether the basis for computing tax liability is fair, i.e., is the business activity subject to taxation accurately reflected by application of the three-factor formula?" *Id.*, at 412.

In its brief to this Court in opposition to the Writ, Respondent argued that the tax that would be paid by Trinova under the statutory formula was not an unreasonable tax burden considering the amount of sales made in the state, a subjective concept of fairness. (P. 26 of Respondent's brief to this Court).

The Michigan decisions, prior to the *Trinova* decision of the Michigan Supreme Court below, had traditionally rejected this mode of analysis. In *J & L*, the Court said:

> In *Donovan [Donovan Construction Co v Department of Treasury*, 126 Mich App 11; 337 NW2d 297 (1983) *lv den* 419 Mich 894 (1984)] and *Payne and Dolan [of Wisconsin, Inc v Department of Treasury*, 138 Mich App 418; 360 NW2d 208 (1984)], the Treasury Department based its request for relief primarily on a showing of gross disparity in tax liability results and not on a showing that the apportionment formula distorted business activity within the state. Therefore, this Court denied relief. Similarly, because the burden of showing distorted activity was not met in *International Telephone & Telegraph Corp, supra*, the

> corporation was not entitled to relief in computing franchise fees. The basis for denial of relief in these cases was *not*, as Respondent suggests, that the resulting franchise fee or tax liability seemed reasonable or not excessive. The inquiry does not turn on the end result; i.e., tax liability. Rather, it turns on whether the basis for computing tax liability is fair; i.e., is the business activity subject to taxation accurately reflected by application of the three-factor formula. (Bracketed material added). 147 Mich App, at 412.

J & L contended that inclusion of the compensation component in the tax base to which the statutory formula was applied resulted in the attribution to Michigan of far more compensation than was actually paid in the state. Based on this contention, *J & L* requested relief under § 69, asking the Commissioner to allow direct allocation of compensation actually paid in the state by the taxpayers, and an apportionment of the remaining components of the SBT base by use of the statutory formula. The Court of Appeals affirmed the decision of the Tribunal holding that the Commissioner erred in denying the requested relief. The Tribunal emphasized two stipulated facts which demonstrated that the three-factor formula unfairly represented business activity in Michigan: the apportionment formula attributed substantially more compensation (50 percent) to Michigan than was actually paid in Michigan, and the compensation attributable to Michigan could be precisely calculated. The Court of Appeals concluded that:

> Petitioners did not merely show a gross disparity in tax liability depending on the accounting method employed. Instead, based on the stipulated facts, petitioners presented evidence which demonstrated that the three factor formula over-apportioned or excessively attributed compensation to Michigan. The facts revealed that the compensation component of business activity subject to taxation was overstated by

> approximately fifty percent. As required by *Donovan, supra,* petitioners presented clear and convincing evidence 'that the statutory formula inadequately or inaccurately represent[ed] [their] unitary business activity in the taxing state'. 145 Mich App at 413.

This Court, in *Container, supra,* has affirmed the fact that the proper focus is not on the end result of an application of the apportionment process, but on the integrity of the process itself. By looking at the external consistency of an apportionment formula, the Court focuses on the fairness of the apportionment process, and not on a subjective test of the reasonableness of resulting tax liability. Amici therefore respectfully suggest that this Court ignore the temptation offered by Defendant to make a determination in this case based upon a comparison of tax liability or whether the tax result seems fair in relation to Trinova's sales in Michigan. That is not the standard advanced under § 69 of the Act nor by the decisions of this Court. This Court should decline the invitation of Defendant to deviate from the *Container* analysis in deciding this case.

Finally, it should be noted that the decision of the Court of Claims in *Trinova* was made as contemplated by the statute. The very existence of an apportionment formula relief provision such as § 69 anticipates that the Commissioner of Revenue and, ultimately, the Courts are to exercise the powers granted in § 69 to remedy those situations which a finder of fact determines to be "unfair". The Court of Claims was not engaged in an extraordinary activity in any sense. The statute provides for apportionment formula modifications. The power is to be exercised in factual circumstances determined by the finder of fact to be "unfair". The Court of Claims was thus completely within the bounds of the authority

granted by the statute in awarding the relief which Trinova was seeking.

SUMARY OF ARGUMENT

To be valid, a state tax on interstate commerce must, among other things, not result in taxing values outside the taxing state. Further, the formula used must contain factors which rationally relate to the tax base being apportioned and how it is generated. The tax at issue fails this standard as to Trinova and Amici, and a modification of the apportionment process such as requested by Trinova and Amici is therefore required.

CONCLUSION

The claim of Trinova which is presented to this Court is based upon the unfair apportionment of Trinova's single business tax base in 1980. Trinova also claims that the single business tax apportionment formula discriminates against taxpayers domiciled outside of the State of Michigan due to the composition of the tax base and the application of equally weighted apportionment factors to that tax base. The discrimination claim is premised upon the adoption of an unfair system of apportionment of a value added tax base designed to promote development and investment within the State of Michigan. As to Trinova and Amici, superimposing the three factor income tax apportionment formula on the single business tax base consisting in the main of non-income related business expenses produces an unfair representation of the business activity of Trinova and Amici. In such a circumstance, the decisions of this Court require that an accommodation be provided to such taxpayers in order to assure that the taxing power of Michigan is confined to

its constitutional limits. A statutory vehicle for such an accommodation exists in the form of § 69 of the Act.

When interpreted in light of the foregoing constitutional adjudications of this Court concerning apportionment, § 69 of the Act, whether before or after amendment, requires an accommodation by the Respondent of an unfair representation of business activity by apportionment which is out of all appropriate proportion to business transacted in the state or which leads to a grossly distorted result. When thus interpreted consistently with the foregoing constitutional determinations of this Court, the objectives of fair apportionment and non-discriminatory taxation of interstate commerce expressed by this Court in *Complete Auto Transit, supra,* may be achieved. For the foregoing reasons, the judgment of the Supreme Court of Michigan in this case should be reversed.

Respectfully submitted,

PATRICK R. VAN TIFLIN
(Counsel of Record)
MYRA L. WILLIS
JAMES H. GEARY
HOWARD & HOWARD ATTORNEYS, P.C.
Phoenix Building, Suite 500
222 Washington Square, North
Lansing, Michigan 48933
(517) 485-1483
Attorney for Alcan Aluminum Corporation, et al.

April 27, 1990

APPENDIX TO AMICUS CURIAE BRIEF OF ALCAN ALUMINUM CORPORATION, ET AL.

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Exhibit 1—§ 69

208.69. RELIEF AS TO TAX BASE

Sec. 69. (1) If the apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commissioner may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) Separate accounting.

(b) The exclusion of any 1 or more of the factors.

(c) The inclusion of 1 or more additional factors which will fairly represent the taxpayer's business activity in this state.

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.

(2) An alternate method will be effective only if it is approved by the commissioner.

Exhibit 2—MTT—"J & L"

STATE OF MICHIGAN
MICHIGAN TAX TRIBUNAL

Jones and Laughlin Steel Corporation, Petitioner	)	
v	)	MTT Docket No. 57892
Michigan Department of Treasury, Respondent	)	
and	)	
Wilson Foods Corporation, Petitioner	)	
v	)	MTT Docket No. 57893
Michigan Department of Treasury, Respondent	)	

OPINION AND JUDGMENT

Tribunal Judge Present
Charles P. McDonald

This matter having come on for hearing before Hearing Officer Roger M. Groves, and briefs having been filed and a Proposed Judgment having been issued from which exceptions and written arguments thereto were filed, and The Tribunal having considered all matters raised and being fully familiar in the premises, does hereby adopt and incorporate by reference the findings of fact and conclusions of law in the said Proposed Judgment, issued April 6, 1984, as the *final* decision of the Tribunal, except as noted hereinafter.

Exhibit 2—MTT—"J & L"

The taxpayers have noted that if the Section 69 relief is granted, they will withdraw from consideration the remaining issues presented. Among such remaining issues is that related to the number of statutory exemptions authorized under Section 35(2) to members of an affiliated group. By stipulation, taxpayers have acknowledged that they were affiliated as defined in Section 3(1) of the Act, but argue that both are entitled to an exemption on the grounds that the statute limiting them to a single exemption is unconstitutional.

This Tribunal does not have the requisite jursdiction to declare a statute unconstitutional; see *Henshaw v State Tax Commission* (*on remand*), 126 Mich App 806, 810; — NW2d — (1983). Accordingly, assuming the statute constitutional and in the absence of any factual dispute remaining, the Tribunal must find only a single exemption allowable, and a revised assessment appropriate.

In all other respects the facts and conclusions in the Proposed Judgment are ADOPTED pursuant to Section 26 of the Tax Tribunal Act.

Judgment

IT IS HEREBY ORDERED AND ADJUDGED that Assessment Numbers B502664 and B506830 be and are hereby CANCELLED.

IT IS FURTHER ORDERED AND ADJUDGED that a revised assessment be issued by Respondent pursuant to allowance of a single statutory exemption.

MICHIGAN TAX TRIBUNAL
By /s/ Charles P. McDonald

Entered: September 5, 1984

Exhibit 2—MTT—"J & L"

STATE OF MICHIGAN
MICHIGAN TAX TRIBUNAL

Jones & Laughlin Steel Corporaton, Petitioner	)	
v	)	MTT Docket No. 57892
Michigan Department of Treasury, Respondent	)	Assessment No. B502664
and	)	Account No. 25-0580280
Wilson Foods Corporation, Petitioner	)	
v	)	MTT Docket No. 57893
Michigan Department of Treasury, Respondent	)	Assessment No. B506830
	)	Account No. 73-0955617

PROPOSED JUDGMENT

Hearing Officer Presiding
Roger M. Groves

Findings of Fact

In this cause a Stipulation of Facts was entered by the parties in contemplation of four issues in controversy. An evidentiary hearing was held regarding the primary issue of whether the Petitioners' single business tax returns properly included an alternative formula under Section 69 of the Single Business Tax Act ("Act"), MCL 208.1 *et seq.;* MSA 7.558(1) *et seq.*, to the statutory three

Exhibit 2—MTT—"J & L"

factor apportionment formula used by the Respondent. Briefs by the parties concerning all contested issues were filed by August 17, 1983.

Both Petitioners were incorporated under the laws of a state other than Michigan; Jones & Laughlin Steel Corporation (hereinafter J & L Steel) in Pennsylvania, and Wilson Foods Corporation (hereinafter Wilson) in Delaware. The principal offices of the Petitioners were also foreign to Michigan, being Pittsburgh, Pennsylvania and Oklahoma City, Oklahoma, respectively. During the tax years in controversy, J & L Steel was engaged in the manufacture of steel and related steel products, which it sold on a nationwide basis. Wilson, during the same relevant tax period, was engaged in the business of manufacturing and selling meat and related meat products, also marketed on a nationwide basis. The Michigan business activities of both Petitioners were primarily the operation of marketing and sales offices. Additionally, J & L Steel had a manufacturing plant in Warren, Michigan. The primarily sales force of J & L Steel has been in Troy, Michigan, with a retail sales outlet in Kalkaska, Michigan. (J & L Stipulation of Facts, paragraph 1, 2 and 3.)

The tax years in controversy are calendar years 1976, 1977 and 1978. (J & L Steel Stipulation of Facts, paragraph 4; Wilson Stipulation of Facts, paragraph 4.)

The cumulative amount in controversy, exclusive of interest, is $556,697 for J & L Steel and $37,694 for Wilson. Notices of Final Assessment to both taxpayers, issued on the same date, September 21, 1981, being No. B502664 and B506830, respectively, reflect those amounts.

For all years in question, both taxpayers utilized the three factor formula from Chapter 3 of the Act when apportioning the business income portion of their respective tax base. Both taxpayers, however, allocated to Michigan the *compensation* portion of their tax base on their SBT returns for all three years, rather than apportion to Michigan, based on total compensation. (J & L Steel's returns are Exhibits P-1, P-2 and P-3; Wilson's returns are Exhibits P-4, P-5 and P-6).

The parties have stipulated that the amount of Michigan compensation for J & L Steel for all years in question was as follows:

Year	Michigan Compensation
1976	$26,385,639
1977	21,629,704
1978	21,782,621

The Michigan compensation of Wilson was also stipulated between the parties for all controverted years:

Year	Michigan Compensation
1976	$91,642
1977	58,811
1978	82,215

(See J & L Steel Stipulation of Facts, paragraph 25 and Wilson Stipulation of Facts, paragraph 25.)

Thus, the amount of compensation attributable to Michigan was known and finitely determined for both taxpayers for all years in question.

Pursuant to audit, the Respondent redetermined the taxpayers' tax base using the three-factor formula to apportion each taxpayer's total compensation rather than allow a specific allocation to Michigan of the admittedly Michigan compensation. The single business tax base for both taxpayers was significantly increased under the compensation apportionment. Respondent's determination of apportioned conmpensation for J & L Steel was as follows:

Tax Year	Michigan Apportioned Compensation
1976	$39,902,544
1977	38,662,908
1978	33,739,177
	(Exhibit P-9)

The corresponding amounts of apportioned compensation as determined for Wilson were as follows:

Tax Year	Michigan Apportioned Compensation
1976	$2,075,400
1977	1,946,831
1978	2,137,480
	(Exhibit P10)

These amounts of compensation represent a substantial majority of the SBT tax base of both taxpayers.[1]

Both taxpayers also calculated their respective excess compensation deductions under Section 31(5) of the Act by utilizing an apportioned tax base, rather than an unapportioned tax base, when determining their "total tax base". The total tax base that would result under both

---

[1]The apportioned compensation comprised between 84.68% and 93.58% of the J & L Steel tax base for the three years, and between 96.57% and 100.99% of the Wilson tax base. (Paragraph 9 of both Stipulations of Fact.)

methods was noted in paragraphs 33 and 34 of the Stipulations of Facts of both parties. (See also Petitioner's Principal Brief, page 7.)

Both taxpayers also excluded from "compensation" as defined in Section 4(3) of the Act amounts of money that are accruals to fund pension, retirement and/or profit sharing plans *prior* to the effective date of the Act.

The parties have also stipulated with Respondent that the taxpayers were "affiliated corporations" as defined in Section 3(1) of the Act, for purposes of determining whether each taxpayer is entitled to the Section 35 statutory exemption. (J & L Steel Stipulation paragraph 35; Wilson Stipulation, paragraphs 35 and 36.)

Both taxpayers requested relief from the use of the apportionment formula under the Act pursuant to Section 69 of the Act. Such requests were denied, giving rise to the cases before this Tribunal.

The taxpayers specifically note on the record and in their collective principal brief that if the Section 69 relief is granted, the taxpayers will withdraw from consideration the other three issues presented in the brief. Regarding those secondary issues, the taxpayers contend (1) that "total tax base" as used in the calculation of the excess compensation deduction [Section 31(5)] was intended to mean "tax base" after apportionment; (2) that accruals of contributions of the taxpayers to retirement plans and other elements of "compensation" as defined in Section 4(3) of the Act cannot be included as compensation when the services that gave rise to the accruals occurred prior

to the effective date of the Act; and (3) that both taxpayers, through members of an affiliated group, still cannot be denied the statutory exemption authorized under Section 35(2). To deny same unconstitutional creates an artificial distinction between affiliated taxpayers and non-affiliated taxpayers who admittedly are similarly situated. While the statute doesn't allow both taxpayers the exemption, the statute is urged as unconstitutional.

Conclusions of Law

The primary issues in this case are: (1) whether the 3-factor formularly apportionment provisions under Section 45 of the Act fairly represent the extent of the taxpayers' respective business activity in Michigan; (2) if not, does the method utilized by the taxpayers in filing their separate SBT returns or the additional methods suggested by taxpayers at hearing, provide a substantially more accurate representation of the extent of the taxpayers' business activity in Michigan. This Tribunal holds that the statutory apportionment formula does *not* fairly reflect the extent of business activity for either taxpayer and that the taxpayers' alternative method in their returns is substantially more accurate in exsecting the Michigan business activity of the taxpayers. Accordingly, relief from the Section 45 apportionment formula is granted under Section 69 of the Act, and is supported by taxpayers' alternate method utilized in its SBT returns.

The statutory apportionment formula provides that "all of the tax base" of a Michigan multi-state taxpayer, except the tax base derived from certain services not applicable

in the instant case or specifically allocated, shall be apportioned to Michigan "by multiplying the tax base by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3". MCL 208.45; MSA 7.588(45).

Section 69 of the Act provides as follows:

> Sec. 69. (1) If the apportionment provisions of this act *do not fairly represent the extent of the taxpayer's business activity in this state*, the taxpayer may petition for or the commissioner may require, in respect to all or *any part* of the taxpayers' business activity, *if reasonable:*
>
> (a) Separate accounting.
>
> (b) The exclusion of any 1 or more of the factors.
>
> (c) The inclusion of 1 or more additional factors which will fairly represent the taxpayer's business activity in this state.
>
> (d) The employment of *any other method* to effecuate an equitable *allocation* and apportionment of the taxpayer's tax base.
>
> (2) An alternate method will be effective only if it is approved by the commissioner. MCL 208.69; MSA 7.558(69) (Emphasis Supplied).

In the instant case, it cannot be held that the apportionment formula in the Act fairly represents the extent of either taxpayer's business activity, when the stipulated actual compensation of J & L Steel is between $12,000,000 and $17,000,000 *less* than the apportionment formula would indicate for each of the three years at issue (Exhibit P-9); and when Wilson's stipulated a actual compensation

is approximately $2,000,000 *less* than the State's apportionment formula attribution to Wilson's Michigan business activity, for each year in question. The apportioned compensation exceeded the actual Michigan compensation by greater than 50% for each taxpayer for every year at issue.

It is significant to note that the pragmatic analysis immediately above is not inconsistent with the theoretical underpinnings of this state's apportionment formula, and the circumstances under which relief from the formula is appropriate. As discussed at length in an earlier Tribunal case[2] dealing with corporate income tax, a forerunner to the SBT Act with virtually the same apportionment formula, Michigan's apportionment formula and relief provisions are derived from the Uniform Division of Income for Tax Purposes Act (UDITPA) and the Multistate Tax Compact (MTC). Michigan has adopted the latter, effective 1970, see 1969 PA 343, MCL 205.281 *et seq.;* MSA 4.146(101) *et seq.* It appears clear that the 3-factor apportionment formula from those sources was designed to be a reasonable statistical *approximation* of each state's equitable share of income of a multistate taxpayer; such a result being necessary because of the extreme difficulty in determining the exact amount of net income by multistate taxpayers attributable to a particular state. Altman and Keesling, *Allocation of Income in State Taxation,* (CCH, 1946, p 108.) The testimony of Mr. Burns Stanley, who

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[2] *Payne & Dolan of Wisconsin, Inc v Department of Treasury,* MTT Docket No. 73934 (1983).

has had extensive experience in apportionment and allocation matters, (Exhibits P-7 and P-8 detail that experience) underscored that point. The utopian result, if the uniform method was utilized in each state was described as follows:

> "The Uniform Act, if adopted in every state having a net income tax or a tax measured by net income, would assure that 100 percent of income, and no more or no less would be taxed." Pierce, *The Uniform Division of Income for State Tax Purposes,* 35 Taxes 747, 748 (1957).

Consistent with the apportionment formula is the necessity for a relief provision. As the taxpayers state in their principal brief, the primary draftsman of UDITPA notes that the relief provision is necessary "where reasonableness requires", in order to accommodate the unusual cases and constitutional entanglements. Pierce, *The Uniform Division of Income for State Tax Purposes,* 35 Taxes 747 (1957). The instant case is the unusual circumstances where the compensation of each taxpayer comprises between 84.68% and 100% of their respective Michigan tax base, all [of] which has been identified and stipulated between the taxpayers and the taxing entity. Where the amount of compensation attributable to a state is known, it is not, in this Tribunal's view, a reasonable or fair representation of state activity to approximate the compensation at over 50% of the actual amounts. It would also be constitutionally troublesome for one state to tax a *substantial* amount of income not generated within the state's borders.

Greyhound Lines, Inc. and Affiliates v. Department of Treasury, Michigan Board of Tax Appeals, Docket No. 976, 1720 (1977).

Having found that the 3-factor formula does not fairly represent the business activity of the taxpayers in this case, it is next necessary to determine whether any of the three alternative methods advocated by these taxpayers comport with the Section 69 relief provision. That provision clearly authorizes an alternate method "in respect to . . . *any part* of the taxpayer's business activity, *if reasonable*" [Section 69(1)].

In this matter, the only part of the taxpayers' business activity altered by their alternate method is the compensation attribution. Under the taxpayers' method, that component is specifically allocated since it is finitely known. The taxpayers do not herein quarrel with the apportionment formula application against all other components of SBT tax base, which were not finitely quantified.

Section 69 also specfically authorizes "any other method" to produce an "equitable *allocation* and apportionment of the taxpayer's tax base". [Section 69(1)(d)].

That provision should be construed to allow the flexibility to combine allocation and apportionment as long as it reasonably reflects the taxpayer's business activity. That combination in this case appears to have accomplished that result because the allocation has eliminated a substantial amount of compensation, which is admittedly not part of the Michigan tax base.

Since the taxpayers' method combines allocation and apportionment, and since the Act also provides for statutory

allocation and apportionment, it is important to distinguish between the taxpayers' use of allocation as only a part of its alternate apportionment formula, and the statutory allocation, which is designed to distribute the entire tax base. Allocation, most fundamentally, means to allot, distribute or assign, *Jacobson v Bowles,* 53 FSupp 532, 534, income property, etc., to one state while apportionment means to divide and distribute proportionally income among different states. *Black's Law Dictionary* 4th Ed (1968), p 128. The allocation formula, which evolved from the UDITPA model, provides that income which has its source entirely from within one state is allocated to that state. Altman and Keesling, *Allocation of Income in State Taxation, supra*[3]. Similarly, under the Act, if all of a taxpayer's business activity is confined to Michigan, the tax base is allocated entirely to Michigan. MCL 208.40; MSA 7.558(40). The historical necessity for apportionment in state income tax jurisprudence, however, was noted by the same source to have arisen in the following context:

> "It is *only the income derived from a source which crosses state lines,* such as business operations extending into more than one state, to which a rule of apportionment must be applied." (Emphasis Supplied).

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[3]To avoid semantic confusion, the application of apportionment could be said to result in allocating X amount to State A, and Y amount to State B (meaning that a particular state received the whole amount due it, though the rest of the business activity of the multistate taxpayer is apportioned among other states, each state getting its allocated share.

It follows that under the single business tax, only business activity that extends to non-Michigan sources is necessarily apportioned. Because in this case, 85-100% of each taxpayer's tax base is compensation confined solely to Michigan, there is no need to apportion that segment of business activity. Rather, the compensation should be allocated since it is almost entirely from Michigan sources. This use of allocation is not the statutory allocation scheme under the Act. Section 40 only codifies allocation in the context of a self-contained method where the entire tax base is confined to Michigan. That statutory allocation formula should not be construed as the only permissible use of allocation. The Act's own relief provision allows for "*any* other method" relating to "all or *any* part" of the business activity.

Having accepted the method advocated by the taxpayers as their first alternative, which is the method utilized in filing their respective SBT returns in each year in question, the Tribunal need not address the other alternative methods set forth by the taxpayers.[4]

Similarly the taxpayers set forth alternate issues in the event the Section 69 relief was not granted. Consistent

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[4]The taxpayers' other methods involved the use of (1) a single factor payroll formula, since the difference between payroll and compensation is very small in this case, and compensation is practically all of the tax base; and (2) reducing the sales factor by 50%, thereby reducing the apportioned sales factor to comport with the actual compensation in Michigan. Thus, all three apportionment factors would be utilized, but one would be modified to reduce the distortion.

with taxpayers' statement of withdrawal of those issues if they prevailed on the principal issue, those issues are not herein resolved.

Respondent's assertion that the Section 69 relief was not requested is unpersuasive. The Respondent has not promulgated rules or prescribed forms for such a request, though authorized, if not required to do so under Section 104(1) of the Act. Nonetheless, the taxpayers did utilize the alternate method in filing their return and did make a request at the departmental informal conference prior to the issuance of the Final Assessment. That request was ruled upon by the Respondent's Decision and Order of Determination in both cases. See, also, *Acco Industries, Inc v Department of Treasury*, MTT Docket No. 40141, 40252, 57826, 57689, at pages 12, 13.

The taxpayers' burden of proof in this single business tax case is wholly analogous to the burden involving the former corporate income tax with regards to relief from the three-factor apportionment formula. Under that former tax, the Michigan Court of Appeals recently stated:

> The party seeking to employ the alternate apportionment method has the burden of showing that the formulary apportionment is inappropriate by clear and convincing evidence. See *Butler Bros v McColgan*, 315 US 501; 62 SCt 701; 86 LEd 991 (1942), *St Johnsbury Trucking Co, Inc v New Hampshire*, 385 A2d 215, 217 (NH, 1978), *Deseret Pharmaceutical Co, Inc v State Tax Comm*, 579 P2d 1322, 1326 (Utah 2d, 1978). See generally, Keesling & Warren, *California's Uniform Division of Income for Tax Purposes Act (Part I)*, 15 UCLA L Rev 156 (1967). Evidence introduced to overcome the formula method of allocation must address each element of the formula's equation. *Butler Bros v McColgan*, 111 P2d 334, 341 (Cal 2d, 1941),

> *aff'd* 315 US 501; 62 SCt 701; 86 LEd 991 (1942). *Donovan Construction Company v State of Michigan*, 126 Mich App 11, 21; 337 NW2d 297 (1983).

In the instant case, the stipulated Michigan compensation in relation to the uncontroverted amount of apportioned compensation provides clear and convincing evidence showing the inappropriateness of the formulary apportionment. Each element of the formula's equation was addressed by the taxpayers as the noncompensation components of the tax base was determined with the formula, and compensation was allocated.

Judgment

IT IS HEREBY ORDERED AND ADJUDGED that assessment numbers B502664 and B506830 be and are hereby CANCELLED.

IT IS FURTHER ORDERED AND ADJUDGED that the parties to this cause of action shall have 20 days from date of entry of this Proposed Judgment to file exceptions and written arguments with the Tribunal consistent with Section 81 of the Administrative Procedures Act [MCLA 24.281; MSA 3.560(181)]. The parties in presenting exceptions and written arguments shall limit them to the evidence and testimony presented to the hearing officer. This Proposed Judgment together with any exceptions and written arguments shall be considered by the Tribunal in arriving at a final decision in this matter pursuant to Section 26 of the Tax Tribunal Act [MCLA 205.726; MSA 7.650(26)]

MICHIGAN TAX TRIBUNAL
By /s/ Roger M. Groves
Hearing Officer

Entered: April 6, 1984

Exhibit 3—Order Denying Leave

AT A SESSION OF THE SUPREME COURT OF THE STATE OF MICHIGAN, Held at the Supreme Court Room, in the City of Lansing, on the 18th day of March in the year of our Lord one thousand nine hundred and eighty-six.

Present the Honorable

G. MENNEN WILLIAMS,
Chief Justice

CHARLES L. LEVIN,
JAMES H. BRICKLEY,
MICHAEL F. CAVANAGH,
PATRICIA J. BOYLE,
DOROTHY COMSTOCK RILEY,
DENNIS W. ARCHER,
Associate Justices

77291
& (23)
77292
& (22)

JONES & LAUGHLIN STEEL CORPORATION,

Petitioner-Appellee,

v

MICHIGAN DEPARTMENT OF TREASURY,

Respondent-Appellant.

SC: 77291
CoA: 80472
MTT: 57892

WILSON FOODS CORPORATION,

Petitioner-Appellee,

v

MICHIGAN DEPARTMENT OF TREASURY,

Respondent-Appellant.

Exhibit 3—Order Denying Leave

SC: 77292
CoA: 80473
MTT: 57893

On order of the Court, the motion by the Motor Vehicle Manufacturers Association of the United States, Inc, to file a brief as amicus curiae in support of the application for leave to appeal is considered, and it is GRANTED. The application for leave to appeal is considered, and it is DENIED, because we are not persuaded that the question presented should be reviewed by this Court.

STATE OF MICHIGAN—ss.

I, CORBIN R. DAVIS, Clerk of the Supreme Court of the State of Michigan, do hereby certify that the foregoing is a true and correct copy of an order entered in said court in said cause; that I have compared the same with the original, and that it is a true transcript therefrom, and the whole of said original order.

IN TESTIMONY WHEREOF, I have hereunto set my hand and affixed the seal of said Supreme Court at Lansing, this 18th day of March in the year of our Lord one thousand nine hundred and eighty-six.

/s/ Corbin R. Davis Clerk.

SEAL

Exhibit 4—Order Denying Reconsideration

AT A SESSION OF THE SUPREME COURT OF THE STATE OF MICHIGAN, Held at the Supreme Court Room, in the City of Lansing, on the 22nd day of October in the year of our Lord one thousand nine hundred and eighty-six.

Present the Honorable

G. MENNEN WILLIAMS,
Chief Justice

CHARLES L. LEVIN,
JAMES H. BRICKLEY,
MICHAEL F. CAVANAGH,
PATRICIA J. BOYLE,
DOROTHY COMSTOCK RILEY,
DENNIS W. ARCHER,
Associate Justices

77291(27)
77292(27)

JONES & LAUGHLIN STEEL CORPORATION,

Petitioner-Appellee,

v

MICHIGAN DEPARTMENT OF TREASURY,

Respondent-Appellant.

SC: 77291
COA: 80472
MTT: 57892

WILSON FOODS CORPORATION,

Petitioner-Appellee,

v

MICHIGAN DEPARTMENT OF TREASURY,

Respondent-Appellant.

SC: 77292
COA: 80473
MTT: 57893

Exhibit 4—Order Denying Reconsideration

On order of the Court, the motion for reconsideration of this Court's order of March 18, 1986 is considered, and it is DENIED, because it does not appear that the order was entered erroneously.

Boyle and Archer, JJ., would grant reconsideration and grant leave to appeal.

STATE OF MICHIGAN—ss.

I, CORBIN R. DAVIS, Clerk of the Supreme Court of Michigan, do hereby certify that the foregoing is a true and correct copy of an order entered in said court in said cause; that I have compared the same with the original, and that it is a true transcript therefrom, and the whole of said original order.

IN TESTIMONY WHEREOF, I have hereunto set my hand and affixed the seal of said Supreme Court at Lansing, this 22nd day of October in the year of our Lord one thousand nine hundred and eighty-six.

/s/ Jacqueline B. MacKinnon
Deputy Clerk.

SEAL

Exhibit 5—Armco

STATE OF MICHIGAN
COURT OF CLAIMS

ARMCO, INC.,

Plaintiff,

v

Case No. 84-9612

STATE OF MICHIGAN,
DEPARTMENT OF TREASURY,
REVENUE DIVISION,

Defendant.

_____/

JUDGMENT ORDER

(Filed June 11, 1986)

At a session of said Court, held in the Town Center Building, Lansing, Michigan, on the 11th day of June, 1986.
PRESENT: HONORABLE MICHAEL G. HARRISON, CIRCUIT JUDGE

This Court, having reviewed evidence presented in this proceeding relating to the request of Plaintiff for relief under Section 69 of the Michigan Single Business Tax Act, 1975 P.A. 228, MCL 208.1 *et seq*, MSA 7.558 (101) *et seq* (herein the "Act"); and

This Court having heard testimony presented by James D. Ryan, senior tax attorney for Armco, Inc., and

This Court having also reviewed the pleadings, the Stipulation of Facts presented to this Court by the parties as well as Plaintiff's Exhibits 1 through 8 and Defendant's Exhibits 1 through 7; and

Exhibit 5—Armco

This Court further finding that application of the statutory three factor apportionment formula against the compensation component of Plaintiff's tax base excessively attributes compensation to Michigan by more than 600% when compared with what the parties have stipulated to have been Plaintiff's Michigan actual compensation for each of the years here at issue; and

This Court further finding that the alternative assignment of compensation as reflected more particularly in Plaintiff's Exhibit 6 will more fairly represent Plaintiff's business activity in this State for each of the years here at issue;

NOW, THEREFORE, IT IS HEREBY ORDERED that:

1. In order to more fairly represent Plaintiff's business activity in Michigan for its tax years 1977, 1978, 1979, 1980, 1981 and 1982, Plaintiff is entitled to relief under Section 69 of the Single Business Tax Act.

2. The measure of the relief to which Plaintiff is entitled is represented by methodology outlined in Plaintiff's Exhibit 6; which applies the three factor apportionment formula under the Act to all components of Plaintiff's tax base except for compensation where, instead of apportionment, there is allocated to this state for each of the years here at issue Michigan actual compensation in the following amounts: 1977, $2,349,074; 1978, $2,454,479; 1979, $2,252,491; 1980, $2,239,340; 1981, $2,465,810; 1982, $2,214,554.

Exhibit 5—Armco

3. As the Section 69 relief to be accorded Plaintiff by allocating compensation to the extent indicated above in paragraph 2 of this Order, Defendant shall refund to Plaintiff One Million Six Hundred Twenty-five Thousand Two Hundred Fifteen and No/100 ($1,625,215.00) Dollars of single business tax, in the aggregate, for all years covered by this dispute, together with interest at the applicable statutory rate.

/s/ Michael G. Harrison
Michael G. Harrison
Circuit Judge

APPROVED FOR ENTRY:

/s/ Charles E. Liken
Charles E. Liken
Assistant Attorney General

Exhibit 6—Friendly

STATE OF MICHIGAN
IN THE COURT OF CLAIMS

FRIENDLY ICE CREAM CORPORATION

Plaintiff,

v Case No. 86-10413-CM

MICHIGAN DEPARTMENT OF TREASURY,

Defendant. HONORABLE CAROLYN STELL

David D. Waddell (P36814)
Fraser Trebilcock Davis & Foster, P.C.
Attorneys for Plaintiff
1000 Michigan National Tower
Lansing, Michigan 48933
(517) 482-5800

ORDER AND JUDGMENT

(Filed February 4, 1987)

At a session of the Court of Claims held in the City of Lansing, Ingham County, State of Michigan on the 24th day of January, 1987.

This matter having come to be heard on Plaintiff's Motion for Summary Disposition, the Court having reviewed the Motion and supporting briefs and briefs in opposition and having heard oral argument by counsel for both parties;

IT IS HEREBY ORDERED AND ADJUDGED that Summary Disposition is granted in favor of Plaintiff with respect to the 1981 and 1982 tax years against Defendant in the amount of $20,698.00 plus interest as allowable by law.

Exhibit 6—Friendly

FURTHERMORE IT IS ORDERED AND ADJUDGED that Summary Disposition is granted in favor of Defendant with respect to the 1983 and 1984 tax years against Plaintiff.

FURTHERMORE IT IS ORDERED AND ADJUDGED that no costs or attorneys fees shall be awarded to either party.

/s/ Carolyn Stell
Honorable Carolyn Stell
Court of Claims Judge
Approved as to form only:

/s/ David D. Waddell
David D. Waddell
Attorney for Plaintiff
Approved as to form only:

/s/ Charles E. Liken
Charles E. Liken
Attorney General

Exhibit 7—MTD

STATE OF MICHIGAN
IN THE COURT OF CLAIMS

MTD PRODUCTS, INC,
an Ohio Corporation,

Plaintiff, File No. 86-10416-CL

v HON. ROBERT HOLMES BELL

MICHIGAN DEPARTMENT OF TREASURY,

Defendant.

OPINION AND ORDER OF THE COURT

This is an action under MCL 208.88; MSA 7.588(88) to recover taxes paid by plaintiff. Now before the Court is plaintiff's motion for summary disposition, asserting there is no genuine issue of material fact and that plaintiff is entitled to judgment as a matter of law. MCR 1985, 2.116(C)(10).

Plaintiff is an Ohio corporation which does business in Michigan. For the privilege of conducting business in Michigan during tax years 1980, 1981, 1982 and 1983, plaintiff paid a total tax of $201,932 under the Single Business Tax Act. On July 31, 1985, plaintiff filed amended single business tax returns for each of the above four years, seeking refund in total of $116,824. The Department of Treasury ("Department") denied plaintiff's request for a refund on November 5, 1985.

I

The Single Business Tax Act ("Act"), MCLA 208.1 *et seq.*; MSA 7.558(1) *et seq.*, imposes a specific tax on

the adjusted tax base of every person who conducts business in Michigan. The "adjusted tax base" is essentially federal taxable income, subject to certain additions and subtractions enumerated at § 9 of the Act. One of these "adjustments," at § 9 (5), requires the taxpayer to add compensation paid its employees to its taxable income. Thus, compensation becomes a part of the adjusted tax base. In order to determine what portion of the adjusted tax base of a corporation like plaintiff, which conducts business within and without Michigan, is taxable as Michigan business activity, a three-factor apportionment formula is applied. Section 45 of the Act provides:

> All of the tax base, other than the tax base derived principally from transportation, financial, or insurance carrier services or specifically allocated, shall be apportioned to this state by multiplying the tax base by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3.

Application of this apportionment formula is designed to produce a reasonable *approximation* of the share of a multi-state taxpayer's business activity which is attributable to Michigan. Because the resultant approximation may be more or less accurate, depending on taxpayer-specific circumstances, relief from the apportionment formula is sometimes available under § 9 of the Act:

> (1) If the apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commission [sic] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

> (a) Separate accounting.
>
> (b) The exclusion of any 1 or more of the factors.
>
> (c) The inclusion of 1 or more additional factors which will fairly represent the taxpayer's business activity in this state.
>
> (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.
>
> (2) An alternate method will be effective only if it is approved by the commissioner.

The original returns filed by plaintiff for tax years 1980 through 1983 employed the Act's apportionment formula in the customary manner. After these returns were accepted and fully processed by the Department, plaintiff learned of a different method which it believed would more accurately represent its Michigan business activity. Plaintiff attempted to take advantage of the relief available under § 69 by filing amended returns which incorporated a two-step apportionment/allocation method. This method includes allocation of plaintiff's actual Michigan compensation expenses, rather than estimation thereof through apportionment. In other words, plaintiff excluded compensation from its pre-apportionment adjusted tax base, contrary to § 9(5). The apportionment formula was applied to plaintiff's adjusted tax base less compensation. Then, the known amount of plaintiff's Michigan compensation expenses was added to the apportionment product to yield that portion of plaintiff's total business activity attributable to Michigan.

The Department refused to approve this alternate two-step method even though the Tax Tribunal and the Court of Appeals had previously recognized it as legitimate and appropriate under similar circumstances. See *Jones & Laughlin Steel Corp v Dep't of Treasury*, 145 Mich App 405; 377 NW2d 397 (1985), *lv den* 424 Mich 894 (1986).

In defense of its decision, the Department contends the *Jones & Laughlin* ruling is not a binding precedent. The Department presents arguments based on other authorities which were largely rejected by the *Jones & Laughlin* court. Adjudication of plaintiff's claim depends almost exclusively upon the force and effect of *Jones & Laughlin*.

The Jones & Laughlin Steel Corporation and Wilson Foods Corporation filed single business tax returns for tax years 1976, 1977 and 1978, using the above-described two-step method. The Department refused to approve the method. The Tax Tribunal overruled the Department, holding (1) that the statutory apportionment formula failed to accurately represent the taxpayers' Michigan business activity; and (2) that the alternate two-step method yielded a substantially more accurate result. *Jones & Laughlin Steel Corp v Dep't of Treasury*, MTT Docket Nos. 57892 and 57893, Opinion & Judgment dated September 5, 1984. The Court of Appeals affirmed the Tax Tribunal judgment. Thus, the Court of Appeals' *Jones & Laughlin* ruling does not establish a broad rule

of general applicability. It is merely an affirmance of the Tax Tribunal's treatment of two taxpayers under the Single Business Tax Act. Yet, while it may be inaccurate to characterize *Jones & Laughlin* as "binding precedent," to the extent the instant fact situation is materially indistinguishable from the one treated in *Jones & Laughlin*, the Court of Appeals' reasoning certainly represents persuasive authority.

Both the Tax Tribunal's and the Court of Appeals' determination that application of the statutory apportionment formula yielded inaccurate results as to Jones & Laughlin Steel and Wilson Foods rested essentially upon two findings:

> (1) that each taxpayer's actual compensation expenses attributable to Michigan was a known amount; and
>
> (2) that application of the statutory apportionment formula to each taxpayer's total compensation expenses yielded an apportioned compensation approximation more than 50% greater than each taxpayer's actual Michigan compensation expenses for each tax year.

Where these two circumstances coincided, it was determined that application of the statutory apportionment formula was unfair, justifying § 69 relief.

It appears both circumstances are present in the instant case as well. While the Department has questioned the accuracy of plaintiff's compensation figures, no documentary evidence has been submitted to refute plaintiff's verified tax returns. Therefore, under MCR 1985, 2.116

(G)(4), the Court is bound to accept as true the compensation figures reflected in plaintiff's tax returns. Further, it appears use of the apportionment formula yields approximations of Michigan compensation which range from 194% to 790% greater than actual Michigan compensation for the tax years at issue.[1] The Department has suggested no viable grounds for distinguishing the *Jones & Laughlin* case from plaintiff's case. Accordingly, the Court hereby adopts the reasoning employed by the Court of Appeals in *Jones & Laughlin* in holding that Act's three-factor apportionment formula fails to accurately represent the extent of plaintiff's Michigan business activity.

II

It follows from the foregoing conclusion that plaintiff is entitled to § 69 relief. However, an alternate method of calculating plaintiff's tax base is effective only if approved by the Department. Plaintiff sought approval of its two-step method through filing amended tax returns. The Department rejected the amended returns based apparently upon its determination that application of the Act's apportionment formula did not yield unfair results. Thus, it appears the Department never considered the appropriateness of plaintiff's alternate method. The prerequisite to the effectiveness of an alternate method, the

[1]The Court notes that even if the Act § 31(5) deduction, discussed *infra*, is accounted for, plaintiff's Michigan compensation is greatly over-estimated by application of the apportionment formula, ranging from 171% to 613% greater than actual compensation for the tax years at issue.

Department's approval, was never actually granted or denied. The Department never reached the question.

When confronted with this situation in *Jones & Laughlin*, the Tax Tribunal noted the Department had not promulgated procedural rules whereby a proposed alternate method could be evaluated. The Tax Tribunal proceeded to establish and apply its own standard. It determined that a proposed method ought to be approved if it provides a "substantially more accurate representation" of the taxpayer's Michigan business activity. The Tax Tribunal determined in *Jones & Laughlin* that the two-step method varied from the Act's apportionment formula in one respect only: its treatment of Michigan compensation expenses. Since the two-step method substituted a known actual amount for an estimated inaccurate amount, the Tax Tribunal concluded the two-step method represented the taxpayer's Michigan business activity with substantially more accuracy than the Act's apportionment formula. As to this finding, there is no genuine issue of material fact. Under the standard established in *Jones & Laughlin*, this finding alone is sufficient to dictate that the Department should have approved the two-step method. Consistent with *Jones & Laughlin*, therefore, the Court holds the Department must accept and approve plaintiff's use of the alternate two-step method.

The Court is not unmindful of the Department's objection. Indeed, the Act's apportionment formula has been recognized as the "preferred method established by the Legislature for determining the extent of a taxpayer's

business activity in Michigan." *Payne & Dolan of Wisconsin, Inc v Dep't of Treasury,* 138 Mich App 418, 424; 360 NW2d 208 (1984). Consistent with this preference, the Department denied plaintiff's request to depart therefrom. Now, based on *Jones & Laughlin,* this Court has overruled [sic] the Department's decision, has found application of the Act's apportionment formula unfair, and has found plaintiff's proposed alternate method substantially more accurate. The Department argues it should be allowed to propose and ultimately employ an alternate method which is even more accurate than plaintiff's two-step method. The Court disagrees.

The Department finds itself in what may be perceived as a disadvantageous position due to its own neglect. Under § 104 of the Act, the Department is empowered and required to promulgate rules governing the Act's implementation. It appears, however, that no rules have been promulgated to govern the procedure whereby the appropriateness of § 69 relief is evaluated. In the absence of such rules, the Tax Tribunal in *Jones & Laughlin* created a determinative standard, discussed *supra.* The standard does not provide for ascertainment of the "most accurate method." It provides simply that if a proposed alternate method is substantially more accurate than the Act's apportionment formula, it should be approved. The standard is not without its shortcomings. However, inasmuch as it represents the Tax Tribunal's reasonable attempt to administer the Act in a manner consistent with legislative intent, it is entitled to this Court's deference. Moreover, the standard has been ratified by the Court of Appeals. Under these circumstances, and considering the present

facts are materially indistinguishable from those reviewed in *Jones & Laughlin,* the Court does not deem it proper to supplant the *Jones & Laughlin* standard with the new one proferred by the Department.

III

The Department further objects to the conjunctive use of plaintiff's two-step method with the deduction permitted under § 31(5) of the Act. Section 31(5) provides that a taxpayer "may elect to reduce the adjusted tax base by the percentage that the compensation divided by the tax bse [sic] exceeds 63%." This deduction is designed to give a tax break to labor-intensive businesses. *Frankenmuth Mutual Ins Co v Dep't of Treasury,* 134 Mich App 489, 495; 350 NW2d 903 (1984). It provides for a deduction from the taxpayer's pre-apportionment adjusted tax base. *Id,* 134 Mich App 496. Compensation exempted from the pre-apportionment adjusted tax base is not included in the numerator of the § 31(5) calculation. Id, 134 Mich App 497. Since, under plaintiff's two-step method, all compensation is excluded from the pre-apportionment adjusted tax base, plaintiff is entitled to no deduction under § 31(5).

IV

Accordingly, plaintiff is entitled to summary disposition under MCR 1985, 2.116(C)(10). The Department is hereby directed to accept and process plaintiff's amended single business tax returns, disallowing any claimed § 31(5) deduction, and refunding any overpayment to which plaintiff is entitled.

Exhibit 7—MTD

IT IS SO ORDERED.

Dated: March 30, 1987

/s/ Robert Holmes Bell
ROBERT HOLMES BELL
CIRCUIT JUDGE

Exhibit 8—AMP

STATE OF MICHIGAN
COURT OF CLAIMS

AMP INCORPORATED,

Plaintiff,

Docket No. 86-10216-CM

vs.

STATE OF MICHIGAN
DEPARTMENT OF TREASURY,
REVENUE DIVISION,

Defendant.

_____/

JUDGMENT ORDER

At a session of said Court, held in the City Hall Building, Lansing, Michigan, on the 27th day of April, of 1987.

PRESENT: HONORABLE MICHAEL G. HARRISON, CIRCUIT JUDGE

This Court, having reviewed evidence presented in this proceeding relating to the request of Plaintiff for relief under Section 69 of the Michigan Single Business Tax Act, 1975 P.A. 228, MCL 208.1 *et seq*, MSA 7.558 (101) *et seq* (herein the "Act"); and

This Court having reviewed the affidavit of Stephen Horoshak, Director of Taxes for AMP Incorporated, and

This Court having also reviewed the pleadings and Plaintiff's Motion for Summary Disposition; and

This Court further finding that application of the statutory three factor apportionment formula against the

compensation component of Plaintiff's tax base excessively attributes compensation to Michigan by more than 350%, when compared with what the parties have admitted to have been Plaintiff's Michigan actual compensation for each of the years here at issue; and

This Court further finding that the alternative assignment of compensation as reflected in Plaintiff's claims will more fairly represent Plaintiff's business activity in this State for each of the years here at issue;

NOW, THEREFORE, IT IS HEREBY ORDERED that:

1. In order to more fairly represent Plaintiff's business activity in Michigan for its tax years 1980, 1981, 1982, 1983 and 1984, Plaintiff is entitled to relief under Section 69 of the Single Business Tax Act.

2. The measure of the relief to which Plaintiff is entitled is represented by methodology outlined in Plaintiff's claim; which applies the three factor apportionment formula under the Act to all components of Plaintiff's tax base except for compensation where, instead of apportionment, there is allocated to this state for each of the years here at issue Michigan actual compensation in the following amounts: 1980, $452,229; 1981, $481,862; 1982, $541,786; 1983, $595,230; 1984, $694,286.

3. As the Section 69 relief to be accorded Plaintiff by allocating compensation to the extent indicated above in paragraph 2 of this Order, Defendant shall refund to Plaintiff One Hundred Fifty-Five Thousand Eight Hundred Forty-Three and No/100 ($155,843.00) Dollars of

single business tax, in the aggregate, for all years covered by this dispute, together with interest at the applicable statutory rate.

/s/ MICHAEL G. HARRISON
MICHAEL G. HARRISON
Circuit Judge

APPROVED FOR ENTRY:

/s/ Charles E. Liken
Charles E. Liken
Assistant Attorney General

Exhibit 9—Trinova

STATE OF MICHIGAN

IN THE COURT OF CLAIMS

TRINOVA CORPORATION, (formerly LIBBEY-OWENS-FORD COMPANY),

Plaintiff,

File No. 86-10430-CM

HON. ROBERT HOLMES BELL

-VS-

STATE OF MICHIGAN, DEPARTMENT OF TREASURY, REVENUE DIVISION,

Defendant.

OPINION AND ORDER OF THE COURT

This case presents an action by plaintiff, Trinova Corporation, to recover an alleged overpayment of taxes under the Single Business Tax Act. The Department of Treasury's answer thereto includes a counterclaim, asserting plaintiff actually owes additional tax for tax year 1980. Both parties have moved for summary disposition under MCR 2.116(C)(9), asserting their opponent has failed to state a valid defense.[1]

---

[1]Normally, a motion for summary disposition under MCR 2.116(C)(9) is based exclusively on the pleadings. Here, however, both parties have asked the Court to also consider a document entitled "Stipulated Facts" in evaluating their motions. Pursuant to this mutual request, this document is herein treated as a pleading in which speaks on behalf of both parties as to both claims before the Court.

Exhibit 9—Trinova

Plaintiff is an Ohio corporation which conducts business in Michigan. For the privilege of doing business in Michigan during tax year 1980, plaintiff paid tax under the Single Business Tax Act ("Act"), MCL 208.1 *et seq.*; MSA 7.558(1) *et seq.* Plaintiff's tax liability for 1980 was computed through application of the Act's § 45 formula. Plaintiff paid this amount, $293,528, in full. In 1985, plaintiff filed an amended single business tax return, requesting the Department of Treasury ("Department") to re-calculate its 1980 tax liability by an alternate method. When the request was denied, plaintiff filed the instant complaint, asking the Court to rule that plaintiff is entitled to use the alternate method and to award a total tax refund of $293,528. In its counterclaim, the Department, too, asserts plaintiff's 1980 single business tax liability ought to have been calculated by an alternate method. According to its proposed method, plaintiff owes additional tax in the amount of $576,804.

I

The Act imposes a specific tax on the adjusted tax base of every person who conducts business in Michigan. The "adjusted tax base" is essentially federal taxable income, subject to certain additions and subtractions enumerated at § 9 of the Act. One of these "adjustments," at § 9(5), requires the taxpayer to add compensation paid its employees to its tax base. Similarly, § 9(4)(e) requires the taxpayer to add to its tax base any tangible assets depreciation deductions which had been subtracted in arriving at federal taxable income. Thus, compensation ex-

penses and an amount equal to depreciation deductions previously taken become part of the adjusted tax base. In order to determine what portion of the adjusted tax base of a corporation like plaintiff, which conducts business within and without Michigan, is taxable as Michigan business activity, a three-factor apportionment formula is applied. Section 45 of the Act provides:

> All of the tax base, other than the tax base derived principally from transportation, financial, or insurance carrier services or specifically allocated, shall be apportioned to this state by multiplying the tax base by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3.

Application of this apportionment formula is designed to produce a reasonable *approximation* of that share of a multi-state taxpayer's business activity which is attributable to Michigan. Because the resultant approximation may be more or less accurate, depending on taxpayer-specific circumstances, relief from the apportionment formula is sometimes available under § 69 of the Act:

> (1) If the apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commission [sic] may require, in respect to all of any part of the taxpayer's business activity, if reasonable:
>
> (a) Separate accounting.
>
> (b) The exclusion of any 1 or more of the factors.

> (c) The inclusion of 1 or more additional factors which will fairly represent the taxpayer's business activity in this state.
>
> (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.
>
> (2) An alternate method will be effective only if it is approved by the commissioner.

Plaintiff attempted to take advantage of this § 69 relief by filing an amended return which incorporated a two-step apportionment/allocation method. This method includes allocation of actual Michigan compensation expenses and actual Michigan depreciation amounts, rather than estimation thereof through apportionment. In other words, plaintiff excluded compensation and depreciation amounts from its preapportionment adjusted tax base, contrary to § 9. The apportionment formula was applied to plaintiff's adjusted tax base less compensation and depreciation. Then, the known amounts of plaintiff's Michigan compensation and depreciation were added to the apportionment product to yield that portion of plaintiff's total business activity attributable to Michigan. The Department refused to approve this alternate two-step method even though the Tax Tribunal and the Court of Appeals had previously recognized it as legitimate and appropriate under similar circumstances. See *Jones & Laughlin Steel Corp v Dep't of Treasury*, 145 Mich App 405; 377 NW2d 397 (1985), *lv den* 424 Mich 894 (1986).

In defense of its decision, the Department contends the *Jones & Laughlin* ruling is not a binding precedent.

The Department presents arguments based on other authorities which were largely rejected by the *Jones & Laughlin* court. Adjudication of plaintiff's claim depends almost exclusively upon the force and effect of *Jones & Laughlin.*

The Jones & Laughlin Steel Corporation and Wilson Foods Corporation filed single business tax returns for tax years 1976, 1977 and 1978, using the above-described two-step method. The Department refused to approve the method. The Tax Tribunal overruled the Department, holding (1) that the statutory apportionment formula failed to accurately represent the taxpayers' Michigan business activity; and (2) that the alternate two-step method yielded a substantially more accurate result. *Jones & Laughlin Steel Corp v Dep't of Treasury*, MTT Docket Nos. 57892 and 57893, Opinion & Judgment dated September 5, 1984. The Court of Appeals affirmed the Tax Tribunal judgment. Thus, the Court of Appeals' *Jones & Laughlin* ruling does not establish a broad rule of general applicability. It is merely an affirmance of the Tax Tribunal's treatment of two taxpayers under the Single Business Tax Act. Yet, while it may be inaccurate to characterize *Jones & Laughlin* as "binding precedent," to the extent the instant fact situation is materially indistinguishable from the one treated in *Jones & Laughlin*, the Court of Appeals' reasoning certainly represents persuasive authority.

Both the Tax Tribunal's and the Court of Appeals' determination that application of the statutory apportionment formula yielded inaccurate results as to Jones &

Laughlin Steel and Wilson Foods rested essentially upon two findings:

> (1) that each taxpayer's actual compensation expenses attributable to Michigan was a known amount; and
>
> (2) that application of the statutory apportionment formula to each taxpayer's total compensation expenses yielded an apportioned compensation approximation more than 50% greater than each taxpayer's actual Michigan compensation expenses for each tax year.

Where these two circumstances coincided, it was determined that application of the statutory apportionment formula was unfair, justifying § 69 relief.

Based on the pleadings, it appears both circumstances are present in the instant case as well, as to both compensation and depreciation. Plaintiff's 1980 apportioned Michigan compensation is approximately 40 times greater than actual compensation ($20,308,006 vs $511,774), while apportioned Michigan depreciation is approximately 1000 times greater than actual depreciation ($2,087,078 vs $2,152).

The Department has suggested no viable grounds for distinguishing *Jones & Laughlin* from plaintiff's case. Instead, the Department argues simply the *Jones & Laughlin* reasoning is defective and should be ignored. Contrary to *Jones & Laughlin*, the Department maintains it is not enough to show that one or even two elements of a taxpayer's business activity are over-estimated by application of the Act's formula. Rather, the Department argues, the

Act's formula should be departed from only if its application results in unfairly high or unfairly low taxation.

The *Jones & Laughlin* court addressed this argument directly as follows:

> The inquiry does not turn on the end result, i.e., tax liability. Rather, it turns on whether the basis for computing tax liability is fair, i.e., is the business activity subject to taxation accurately reflected by application of the three factor formula? 145 Mich App 412.

The Court of Appeals went on to hold that where even just one element of business activity is shown, by clear and convincing evidence, to be inaccurately represented by application of the apportionment formula, § 69 relief is available.

Whether this Court agrees entirely with this ruling is immaterial. It is this Court's function to interpret and apply the Single Business Tax Act in accordance with legislative intent and the pronouncements of the state's higher courts. Accordingly, the Court believes the Court of Appeals' *Jones & McLaughlin* decision is entitled to more respect than the Department is willing to acknowledge. The Court hereby adopts the reasoning employed therein and holds as a matter of law based on the pleadings that the Act's apportionment formula fails to accurately represent plaintiff's Michigan business activity.

II

It follows that plaintiff is entitled to § 69 relief. However, an alternate method of calculating plaintiff's tax base is effective only if approved by the Department. It

appears the Department never passed upon the appropriateness of plaintiff's proposed alternate two-step method because it believed the Act's formula was suitable. When confronted with this situation in *Jones & Laughlin*, the Tax Tribunal noted the Department had not promulgated procedural rules whereby a proposed alternate method could be evaluated. The Tax Tribunal proceeded to establish and apply its own standard. It determined that a proposed method ought to be approved if it provides a "substantially more accurate representation" of the taxpayer's Michigan business activity. The Tax Tribunal determined in *Jones & Laughlin* that the two-step method varied from the Act's apportionment formula in one respect only: its treatment of Michigan's compensation expenses. Since the two-step method substituted a known actual amount for an estimated inaccurate amount, the Tax Tribunal concluded the two-step method represented the taxpayer's Michigan business activity with substantially more accuracy than the Act's apportionment formula. Thus, the taxpayers were permitted to use the two-step method over the Department's objection. The Court of Appeals affirmed this result.

Here, the pleadings suggest similar treatment is justified. Applying the standard established in *Jones & Laughlin*, it is clear the Department should have approved plaintiff's proposed two-step method. It represents plaintiff's Michigan compensation and depreciation with substantially more accuracy than the Act's apportionment formula and does not further distort any other element of plaintiff's business activity. The Department has not

disputed this fact, but objects to the resultant reduction in plaintiff's tax liability. Consistent with the Court of Appeals' rejection of this argument, the Court concludes the Department has failed to state a valid defense. Plaintiff's unrefuted allegation that the two-step method represents two elements of its business activity with substantially more accuracy than the apportionment formula justifies summary declaration in plaintiff's favor. Whether plaintiff is entitled to refund or tax paid, however, is a question which depends in part upon resolution of the Department's counterclaim.

Although the Department, in defending against plaintiff's claim, contends the Act's formula does fairly represent plaintiff's 1980 Michigan business activity, its counterclaim asserts the contrary position. The Department alleges therein that application of the Act's formula fails to fairly represent (1) "the extent of Plaintiff's use of the State of Michigan as a market for its products;" and (2) "the significant amount of receipts which Plaintiff derives from its business activities in Michigan." The Department proposes an alternate method based solely upon plaintiff's Michigan sales. This method, too, is said to represent plaintiff's Michigan business activity substantially more accurately than the Act's apportionment formula. Asserting plaintiff has stated no valid defense to the claim, the Department moves for summary disposition in its favor.

Plaintiff admits its actual 1980 Michigan "sales," (gross receipts obtained in consideration for transfer of inventory to customers in the ordinary course of business and for performance of services), amounted to

$103,981,354. Using the Act's formula, Michigan sales were estimated to be only $35,196,000. While admitting this circumstance may justify departure from the Act's formula, plaintiff contends the Department's proposed alternate method is not substantially more accurate. In fact, both parties acknowledge that use of the Department's proposed one-factor formula results in even more extreme exaggerations of plaintiff's Michigan compensation and depreciation than use of the Act's formula. (Stipulated Facts, pp 6, 7.) The very evil which the Tax Tribunal and Court of Appeals sought to avoid in *Jones & Laughlin*, taxation of extra-territorial business activity, is thus compounded by use of the Department's proposed formula. This cannot be permitted. The Court must conclude the Department's proposed one-factor method does not represent plaintiff's business activity with substantially more accuracy than the Act's apportionment formula.

It must be remembered that the Act's apportionment formula has been recognized as the "preferred method established by the Legislature for determining the extent of a taxpayer's business activity in Michigan." *Payne & Dolan of Wisconsin, Inc v Dep't of Treasury*, 138 Mich App 418, 424; 360 NW2d 208 (1984). The two-step method proposed by plaintiff, *supra*, pays deference to this preference by departing therefrom minimally. It applies the Act's apportionment formula to all elements of plaintiff's tax base except compensation and depreciation. It further ensures that plaintiff's compensation and depreciation are even more accurately represented by allocating the actual amounts. While plaintiff's two-step method does not cor-

rect the under-estimation of plaintiff's Michigan sales caused by use of the Act's formula, neither does it compound the distortion. Plaintiff's method does not represent its business activity with perfect exactitude, but it is superior to the Act's formula.

On the other hand, the Department's proposed alternate method represents a profound departure from the Act's formula. It replaces the legislatively preferred three-factor formula with a one-factor (sales) formula, eliminating the payroll and property factors from the equation. Not only does it appear to attach inordinate importance to plaintiff's sales, but it greatly distorts plaintiff's compensation and depreciation expenses. It is anything but an improvement upon the Act's formula.

The Court finds that plaintiff has stated a valid defense to the counterclaim. The Department's motion for summary disposition must be denied. Furthermore, the pleadings compel the conclusion that, as to the Department's counterclaim, there is no genuine issue of material fact. As a matter of law, the Court holds the Department's proposed alternate method is not substantially more accurate than the Act's formula. The Department is not entitled under § 69 of the Act to employ its proposed one-factor formula in determining plaintiff's single business tax. Plaintiff is entitled to summary disposition under MCR 2.116(I)(1).

Based on the premises, the Department's counterclaim is hereby dismissed. Further, plaintiff is awarded summary disposition as to its claim under MCR 2.116(C)(9). The Department is hereby directed to accept and process

plaintiff's amended single business tax returns for tax year 1980, refunding any overpayment and interest to which plaintiff is entitled.

IT IS SO ORDERED.

Dated: May 5, 1987

/s/ Robert Holmes Bell
ROBERT HOLMES BELL
CIRCUIT JUDGE sitting in
the Court of Claims

STATE OF MICHIGAN
IN THE COURT OF CLAIMS

PENTON/INDUSTRIAL
PUBLISHING CO., INC.,

Plaintiff,

-VS-

STATE OF MICHIGAN,
DEPARTMENT OF TREASURY,
REVENUE DIVISION,

Defendant.

File 86-10231-CM

HON. ROBERT
HOLMES BELL

OPINION AND ORDER OF THE COURT

This is an action under MCL 208.88; MSA 7.558(88) to recover taxes paid by plaintiff. Now before the Court are cross-motions for summary disposition based upon the pleadings.

Plaintiff, Penton/Industrial Publishing Co., Inc., is a Delaware Corporation whose principal office is in Cleveland, Ohio. Plaintiff conducts business in Michigan, operating an advertising sales office and employing eight persons. For the privilege of doing business in Michigan during tax years 1980, 1981, 1982 and 1983, plaintiff paid tax under the Single Business Tax Act ("Act"), MCL 208.1 *et seq.*; MSA 7.558(1) *et seq.* Plaintiff's tax liability for each year was computed through application of the

Act's § 45 apportionment formula. Plaintiff's requests to use an alternate formula which would have yielded a smaller tax liability for each year, have been denied by the Department of Treasury ("Department"). The Court is asked to rule that plaintiff is entitled to use the alternate formula and to award a total tax refund of $28,275.

I

The Single Business Tax Act imposes a specific tax on the adjusted tax base of every person who conducts business in Michigan. The "adjusted tax base" is essentially federal taxable income, subject to certain additions and subtractions enumerated at § 9 of the Act. One of these "adjustments," at § 9 (5), requires the taxpayer to add compensation paid its employees to its taxable income. Thus, compensation becomes a part of the adjusted tax base. In order to determine what portion of the adjusted tax base of a corporation like plaintiff, which conducts business within and without Michigan, is taxable as Michigan business activity, a three-factor apportionment formula is applied. Section 45 of the Act provides:

> All of the tax base, other than the tax base derived principally from transportation, financial or insurance carrier services or specifically allocated, shall be apportioned to this state by multiplying the tax base by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3.

Application of this apportionment formula is designed to produce a reasonable *approximation* of that share of a multistate taxpayer's business activity which is attribut-

able to Michigan. Because the resultant approximation may be more or less accurate, depending on taxpayer-specific circumstances, relief from the apportionment formula is sometimes available under § 69 of the Act:

> (1) If the apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commission [sic] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (a) Separate accounting.
>
> (b) The exclusion of any 1 or more of the factors.
>
> (c) The inclusion of 1 or more additional factors which will fairly represent the taxpayer's business activity in this state.
>
> (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.
>
> (2) An alternate method will be effective only if it is approved by the commissioner.

Plaintiff attempted to take advantage of the relief available under § 69 by filing returns which incorporated a two-step apportionment/allocation method. This method includes allocation of plaintiff's actual Michigan compensation expenses, rather than estimation thereof through apportionment. In other words, plaintiff excluded compensation from its pre-apportionment adjusted tax base, contrary to § 9(5). The apportionment formula was applied to plaintiff's adjusted tax base less compensation. Then, the known amount of plaintiff's Michigan compensation expenses was added to the apportionment product

to yield that portion of plaintiff's total business activity attributable to Michigan. The Department refused to approve this alternate two-step method even though the Tax Tribunal and the Court of Appeals had previously recognized it as legitimate and appropriate under similar circumstances. See *Jones & Laughlin Steel Corp v Dep't of Treasury*, 145 Mich App 405; 377 NW2d 397 (1985), *lv den* 424 Mich 894 (1986).

In defense of its decision, the Department contends the *Jones & Laughlin* ruling is not a binding precedent. The Department presents arguments based on other authorities which were largely rejected by the *Jones & Laughlin* court. Adjudication of plaintiff's claim depends almost exclusively upon the force and effect of *Jones & Laughlin*.

The Jones & Laughlin Steel Corporation and Wilson Foods Corporation filed single business tax returns for tax years 1976, 1977 and 1978, using the above-described two-step method. The Department refused to approve the method. The Tax Tribunal overruled the Department, holding (1) that the statutory apportionment formula failed to accurately represent the taxpayer's Michigan business activity; and (2) that the alternate two-step method. The Tax Tribunal overruled the Department, *Jones & Laughlin Steel Corp v Dep't of Treasury*, MTT Docket Nos. 57892 and 57893, Opinion & Judgment dated September 5, 1984. The Court of Appeals affirmed the Tax Tribunal judgment. Thus, the Court of Appeals' *Jones & Laughlin* ruling does not establish a broad rule of general applicability. It is merely an affirmance of the Tax Tribunal's treatment of two taxpayers under the Single Business Tax Act. Yet, while it may be inaccurate

to characterize *Jones & Laughlin* as "binding precedent," to the extent the instant fact situation is materially indistinguishable from the one treated in *Jones & Laughlin*, the Court of Appeals' reasoning certainly represents persuasive authority.

Both the Tax Tribunal's and the Court of Appeals' determination that application of the statutory apportionment formula yielded inaccurate results as to Jones & Laughlin Steel and Wilson Foods rested essentially upon two findings:

> (1) that each taxpayer's actual compensation expenses attributable to Michigan was a known amount; and
>
> (2) that application of the statutory apportionment formula to each taxpayer's total compensation expenses yielded an apportioned compensation approximation more than 50% greater than each taxpayer's actual Michigan compensation expenses for each tax year.

Where these two circumstances coincided, it was determined that application of the statutory apportionment formula was unfair, justifying § 69 relief.

Plaintiff has alleged both circumstances are present in the instant case as well, asserting its apportioned Michigan compensation is more than 100% greater than actual Michigan compensation for each tax year at issue. The Department, in its answer, has admitted these allegations, but maintains they are inconsequential. Unable to distinguish the present facts from those treated in *Jones & Laughlin*, the Department argues simply the *Jones & Laughlin* reasoning is defective and should be ignored.

Contrary to *Jones & Laughlin*, the Department maintains it is not enough to show that one element of a taxpayer's business activity is over-estimated by application of the Act's formula. Rather, the Department argues, the Act's formula should be departed from only if its application results in unfairly high or unfairly low taxation.

The *Jones & Laughlin* court addressed this argument directly, as follows:

> The inquiry does not turn on the end result, i.e., tax liability. Rather, it turns on whether the basis for computing tax liability is fair, i.e., is the business activity subject to taxation accurately reflected by application of the three-factor formula? 145 Mich App 412.

The Court of Appeals went on to hold that where even just one element of business activity is shown, by clear and convincing evidence, to be inaccurately represented by application of the apportionment formula, § 69 relief is available.

Whether this Court agrees entirely with this ruling is immaterial. It is this Court's function to interpret and apply the Single Business Tax Act in accordance with legislative intent and the pronouncements of the state's higher courts. Accordingly, the Court believes the Court of Appeals' *Jones & Laughlin* decision is entitled to more respect than the Department is willing to acknowledge. The Court hereby adopts the reasoning employed therein and holds the Act's three-factor apportionment formula fails to accurately represent the extent of plaintiff's Michigan business activity.

II

It follows that plaintiff is entitled to § 69 relief. However, an alternate method of calculating plaintiff's tax base is effective only if approved by the Department. It appears the Department never passed upon the appropriateness of plaintiff's proposed alternate two-step method because it believed the Act's formula was suitable. When confronted with this situation in *Jones & Laughlin*, the Tax Tribunal noted the Department had not promulgated procedural rules whereby a proposed alternate method could be evaluated. The Tax Tribunal proceeded to establish and apply its own standard. It determined that a proposed method ought to be approved if it provides a "substantially more accurate representation" of the taxpayer's Michigan business activity. The Tax Tribunal determined in *Jones & Laughlin* that the two-step method varied from the Act's apportionment formula in one respect only: its treatment of Michigan compensation expenses. Since the two-step method substituted a known actual amount for an estimated inaccurate amount, the Tax Tribunal concluded the two-step method represented the taxpayer's Michigan business activity with substantially more accuracy than the Act's apportionment formula. Thus, the taxpayers were permitted to employ the two-step method over the Department's objection. The Court of Appeals affirmed this result.

Here, plaintiff's unrefuted allegations justify similar treatment. Applying the standard established in *Jones & Laughlin*, it is clear the Department should have approved the two-step method. It represents plaintiff's Michigan

compensation expenses with substantially more accuracy than the Act's apportionment formula. The Department has failed to state a valid defense to the claim.[1] Consistent with *Jones & Laughlin*, therefore, the Court holds the Department must accept and approve plaintiff's use of the alternate two-step method.

The Department's objection to this result is understandable. Indeed, the Act's apportionment formula has been recognized as the "preferred method established by the Legislature for determining the extent of a taxpayer's business activity in Michigan." *Payne & Dolan of Wisconsin, Inc v Dep't of Treasury*, 138 Mich App 418, 424; 360 NW2d 208 (1984). Consistent with this preference, the Department denied plaintiff's requests to depart therefrom. Now, based on *Jones & Laughlin* and the pleadings here presented, the Court has concluded as a matter of law (1) that application of the Act's formula is unfair, (2) that plaintiff's proposed alternate method is substantially more accurate, and (3) that the Department must approve plaintiff's use of the alternate method. The Department argues that even if these first two conclusions are assumed to be true, they do not compel the third conclusion. Rather, the Department contends, the first two

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[1] In paragraph 3 of its answer, the Department raised the statute of limitations as a bar to plaintiff's claim for refund of its alleged 1980 tax overpayment. Inasmuch as this defense has not been incorporated as an affirmative defense under a separate and distinct heading in the answer, as required by MCR 2.111(3), and has not been advanced in support of the Department's motion for summary disposition, it is deemed waived.

conclusions merely open the door to an inquiry as to which of potentially several alternate methods would *best* represent the taxpayer's Michigan business activity. This inquiry is said to raise a question of fact which precludes summary disposition based on the pleadings. The Court disagrees.

The Department finds itself in what may be perceived as a disadvantageous position due to its own neglect. Under 104 of the Act, the Department is empowered and required to promulgate rules governing the Act's implementation. It appears, however, that no rules have been promulgated to govern the procedure whereby the appropriateness of § 69 relief is evaluated. In the absence of such rules, the Tax Tribunal in *Jones & Laughlin* created a determinative standard, discussed *supra*. The standard does not provide for ascertainment of the "most accurate method." It provides simply that if a proposed alternate method is substantially more accurate than the Act's apportionment formula, it should be approved. The standard is not without its shortcomings. However, inasmuch as it represents the Tax Tribunal's reasonable attempt to administer the Act in a manner consistent with legislative intent, it is entitled to this Court's deference. Moreover, the standard has been ratified by the Court of Appeals. Under these circumstances, and considering the facts here alleged are materially indistinguishable from those reviewed in *Jones & Laughlin*, the Court does not deem it proper to supplant the *Jones & Laughlin* standard with the new one proffered by the Department.

III

Accordingly, the Court holds as follows: (1) the Department's motion for summary disposition under MCR 2.116(C)(8) is denied; (2) plaintiff's motion for summary disposition under MCR 2.116(C)(9) is granted;[2] and (3) the Department shall accept and process plaintiff's single business tax returns for tax years 1980, 1981, 1982 and 1983; employing the alternate two-step method, and refunding any overpayment and interest to which plaintiff is entitled.

IT IS SO ORDERED.

/s/ Robert Holmes Bell
ROBERT HOLMES BELL
CIRCUIT JUDGE sitting in
the Court of Claim

Dated: May 22, 1987

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[2]This holding renders the Department's pending motion to compel answers to interrogatories moot. The motion is denied without further consideration.

STATE OF MICHIGAN

84th LEGISLATURE

REGULAR SESSION OF 1987

Introduced by Reps. Jondahl, Bryant, Berman, Smith, Brown, Weeks, Hickner, Hunter, Murphy, Browne, Trim and Van Singel

ENROLLED HOUSE BILL NO. 4398

AN ACT to amend section 69 of Act No. 228 of the Public Acts of 1975, entitled "An act to provide for the imposition, levy, computation, collection, assessment and enforcement, by lien or otherwise, of taxes on certain commercial, business, and financial activities; to prescribe the manner and times of making certain reports and paying taxes; to prescribe the powers and duties of public officers and state departments; to permit the inspection of records of taxpayers; to provide for interest and penalties on unpaid taxes; to provide exemptions, credits, and refunds; to provide penalties; to provide for the disposition of funds; to provide for the interrelation of this act with other acts; and to provide an appropriation," being section 208.69 of the Michigan Compiled Laws.

The People of the State of Michigan enact:

Section 1. Section 69 of Act No. 228 of the Public Acts of 1975, being section 208.69 of the Michigan Compiled Laws, is amended to read as follows:

Sec. 69.(1) If the apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition

for or the commissioner may require the following, in respect to all or a part of the taxpayer's business activity, if reasonable:

(a) Separate accounting.

(b) The exclusion of 1 or more of the factors.

(c) The inclusion of 1 or more additional factors which will fairly represent the taxpayer's business activity in this state.

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.

(2) An alternate method will be effective only if it is approved by the commissioner.

(3) The apportionment provisions of this act shall fairly represent the business activity attributed to the taxpayer in this state, taken as a whole and without a separate examination of the specific elements of the tax base such as depreciation, compensation, or income, unless it can be demonstrated that the business activity attributed to the taxpayer in this state is out of all appropriate proportion to the actual business transacted in this state and leads to a grossly distorted result. A taxpayer's business activity shall be presumed to be fairly represented if the adjusted tax base computed without regard to the reduction based upon gross receipts permitted by section 31(2) is not greater than the adjusted tax base computed after application of the reduction based upon gross receipts permitted by section 31(2) or if the adjusted tax base is not

greater than the adjusted tax base which would result from an apportioned tax base computed by using the apportionment formula prescribed for a corporate income tax or franchise tax in the taxpayer's business domicile. The taxpayer's business domicile is the state in which the sum of the taxpayer's payroll factor and property factor is greatest. However, if the taxpayer fails to satisfy either of these tests, the taxpayer's business activity shall not be presumed to not be fairly represented.

(4) The filing of a return or an amended return shall not be considered a petition for the purposes of subsection (1).

(5) As used in this section, "adjusted tax base" means that term as defined in section 31.

Section 2. This amendatory act is curative, expressing the original intent of the legislature that the single business tax imposed under the single business tax act, Act No. 228 of the Public Acts of 1975, being sections 208.1 to 208.145 of the Michigan Compiled Laws, is an indivisible value added type of tax and not a combination or series of several smaller taxes and that relief from formulary apportionment should be granted only under extraordinary circumstances. This amendatory act clarifies the existing procedures and standards for granting relief under section 69 of the single business act, Act No. 228 of the Public Acts of 1975, being section 208.69 of the Michigan Compiled Laws.

This act is ordered to take immediate effect.

/s/ David H. Evans
Clerk of the House of Representatives.

/s/ Illegible
Secretary of the Senate.

Approved .....

.....

Governor.

STATE OF MICHIGAN
COURT OF CLAIMS

CONSOLIDATION COAL COMPANY,

Plaintiff, Docket No. 82-8407
HON. THOMAS L. BROWN

v

REVENUE DIVISION,
DEPARTMENT OF TREASURY,
STATE OF MICHIGAN,

Defendant.

Patrick R. Van Tiflin (P26119)
Attorney for Plaintiff
Foster,Swift, Collins & Coey, P.C.
313 South Washington Square
Lansing, Michigan 48933

Curtis G. Beck (P10600)
Assistant Attorney General
Attorney for Defendant

ORDER AND JUDGMENT

At a session of said Court held in the Circuit Courtrooms in City Hall in the city of Lansing, county of Ingham, state of Michigan, on the 27th day of Aug., 1987.

PRESENT: Honorable Thomas L. Brown, presiding.

This matter having come on for hearing on August 21, 1987 on Plaintiff's Motion for Summary Disposition, and the Court having reviewed the Stipulation of Facts and Plaintiff's Motion, Brief and Affidavit in support of

said Motion, and the Court having heard oral argument thereon and being otherwise duly advised in the premises; NOW THEREFORE IT IS

ORDERED, that Plaintiff's Motion for Summary Disposition is granted for the reason that, pursuant to MCR 2.116(C)(9), the Defendant has failed to state a valid defense to the claim asserted against it by the Plaintiff, the Court finding that Defendant's asserted defense of 1987 Public Act 39 is not applicable to Plaintiff's claim for refund herein, and further, pursuant to MCR 2.116(C)(10) for the reason that the result in this case is governed by § 69 of the Single Business Tax Act as originally enacted and as interpreted and applied by the Michigan Court of Appeals in *Jones & Laughlin Steel Corporation v Michigan Department of Treasury*, 145 Mich App 405, 377 NW2d 397 (1985), *lv den* 424 Mich 895 (1986), *mot for reconsid den* 424 Mich 895 (1986) and there is no genuine issue as to any material fact and the Plaintiff is entitled to judgment as a matter of law in the amount of $1,427,532.00 together with interest thereon calculated in accordance with MCLA 205.30.

/s/ Thomas L. Brown
Honorable Thomas L. Brown
Court of Claims Judge

Approved as to form:

/s/ Curtis G. Beck
Curtis G. Beck (P10060)
Attorney for Defendant
Entered on this 27 day of August, 1987.

/s/ Donna Willett
Ingham County Circuit Court Clerk

Exhibit 13—Digital

STATE OF MICHIGAN
IN THE COURT OF CLAIMS

DIGITAL EQUIPMENT CORPORATION,

Plaintiff,

v

STATE OF MICHIGAN,
DEPARTMENT OF TREASURY,
REVENUE DIVISION,

Defendant.

OPINION AND ORDER

File No. 86-10484-CM

Hon. James T. Kallman

This Court, having heard oral arguments of counsel, having reviewed the file and being fully advised in the premises, makes the following determinations:

This matter is before the Court of defendant's motion for summary disposition. The motion is brought pursuant to MCR 2.116(C)(8), failure to state a claim upon which relief may be granted.

Plaintiff filed this claim for a tax refund under the Single Business Tax Act as interpreted by *Jones v MDOT* 145 Mich pp [sic] 405 (1985) lv den 424 Mich 895 (1986) reconsideration den 424 Mich 895 (1986). Defendant claims 1987 PA 39 effective June 9, 1987 applies to plaintiff's claims. This court does not agree. This Court finds that 1987 PA 39 is not applicable to plaintiff's claim for a refund for the reasons stated by the defendant. Judge Brown has already made a similar ruling in *Consolidated Coal v MDOT* 82-8407-CM, order dated August 27, 1987.

Exhibit 13—Digital

It is ORDERED, ADJUDGED AND DECREED that defendant's motion for summary disposition is hereby denied.

DATED: November 2, 1987

/s/ James T. Kallman
James T. Kallman
Court of Claims Judge

Exhibit 14—First Wisconsin

STATE OF MICHIGAN
IN THE COURT OF CLAIMS

FIRST WISCONSIN FINANCIAL CORPORATION,

Plaintiff, Docket No. 87-11132-CM

v. HON. CAROLYN STELL

REVENUE DIVISION, DEPARTMENT OF TREASURY, STATE OF MICHIGAN,

Defendant.

Patrick R. Van Tiflin (P26119)
FOSTER, SWIFT, COLLINS & COEY, P.C.
Attorneys for Plaintiff
313 South Washington Square
Lansing, MI 48933
517/372-8050

Curtis G. Beck (P10600)
Assistant Attorney General
Attorney for Defendant
First Floor, Treasury Building
Lansing, MI 48913
517/373-1142

ORDER AND JUDGMENT

At a session of said Court, held in the Circuit Courtrooms in Town Center, Lansing, Michigan, on the 25th day of November, 1987.

PRESENT: HONORABLE CAROLYN STELL, Circuit Judge, Presiding

This matter having come on for hearing before this Court on Wednesday, October 21, 1987, on Plaintiff's Motion for Summary Disposition of its Complaint for Refund of Single Business Tax, and the Court having reviewed the pleadings filed by the respective parties in support of and in opposition to Plaintiff's Motion, and the Court having conducted a hearing and heard the oral argument of counsel for the parties, and being otherwise duly advised in the premises, and the Court finding as follows:

Exhibit 14—First Wisconsin

Defendant basically admits the factual paragraphs of Plaintiff's motion. The Defendant's response is that first, *Jones and Laughlin* is clearly not a correct interpretation of the original legislative intent and, two, that the use of the statutory three-factor formula does result in a fair reflection of Plaintiff's Michigan business activity.

With respect to the first argument, *Jones & Laughlin* may not be a correct interpretation, but it is the interpretation of the Michigan Court of Appeals which has been allowed to stand by the Michigan Supreme Court's refusal to hear the case. Therefore, it is the law that this Court must follow. *Jones and Laughlin* says that the proper test for invoking Section 69 is whether the taxpayer's Michigan tax base as derived from the application of the three-factor apportionment formula to its adjusted tax base accurately reflects the extent of the taxpayer's business activity within the state.

Defendant cites 1987 P.A. 39 which offers an expression of the original intent of the Legislature. P.A. 39 provides that specific elements such as income should not be separately examined unless it can be demonstrated that the business activity attributed to the taxpayer in the

state is out of all proportion to the actual business transacted in the state and leads to a grossly distorted result. Plaintiff responds by arguing that Defendant has not pled this as an affirmative defense and therefore is untimely. The scheduling conference order was signed on August 31st, 1987 by this Court, and it set September 30th, 1987, as a deadline for amending pleadings. I would note that in fact, as is set forth in the scheduling conference order, that because of my experience with these two counsel and because we've had many of these cases together, counsel themselves met and established these deadlines which were acceptable to the Court. So this is not some kind of artificial deadline imposed upon counsel by the Court, and counsel met to do so on August 26, 1987. This statute had been signed on June 9th, 1987. Therefore, counsel were aware at the time they met of the availability of this defense.

The Court holds that it is untimely and would not consider it for that reason. However, ruling in the alternative so that, in the end, if a reviewing court should find it was not untimely and that the Court is wrong in denying Defendant's oral motion to amend, I am going to consider it under several other theories. First, it appears to me that the Amendment presents two significant constitutional problems. The first is the issue of retroactivity and the situation is such that, as Plaintiff's counsel has pointed out, the law was not really in a state of flux. It was in a state of the Department of Treasury disagreeing very strenuously with an appellate court decision. But it was not the kind of situation in which retroactivity normally is granted on the theory that everybody knew everything was up in the air and therefore they should have been prepared for whatever result came down.

Secondly, I think that it presents constitutional problems under the commerce clause as detailed by Plaintiff's counsel. So, I would disregard it because of those constitutional problems. However, in the alternative, should a reviewing court find there are no constitutional problems either with the application of it retroactively or with the impact this has on the US Commerce Clause, I would make findings on a factual basis, and I would note that when a motion is made under MCR 2.116(C)(10), that an affidavit or supporting documentary evidence is required. That requirement was met by Plaintiff, both by affidavit and by citing to specific paragraphs in the Plaintiff's First Request for Admissions. MCR 2.116(G)(4) requires that the opposing party cannot simply deny, but must respond either by affidavit or other means set forth in the rule, and in the event of a failure to do so, that judgment shall be granted in favor of the moving party if it is appropriate. Here, in looking at the facts, Plaintiff is a Wisconsin business corporation with its principal office in Milwaukee. Its business activity in Michigan consists of the issuance of loans to Michigan borrowers through Plaintiff's Milwaukee office. Plaintiff had no Michigan employees. For the years in question, Defendant calculated compensation paid by the Plaintiff and included it in the tax base. This ranged from $629,103 to $2,172,699, and represented as a percentage of the tax base between 23 and 166 percent.

Exhibit 14—First Wisconsin

Defendant also calculated Section 65 apportionment formula factors for the Plaintiff in a range from .083806 to .192319, resulting in a tax base apportioned to Michigan ranging from $188,870 to $1,071,137. The apportioned compensation ranged from $52,730 to $400,238, while the actual compensation for each of the challenged years was zero. It is easy to observe that the apportioned compensation grossly exceeded the actual compensation.

The Court finds that the totality of these circumstances results in a grossly distorted result even under P.A. 39 and therefore summary disposition is appropriate.

Defendant also raises a statute of limitations defense with respect to tax years 1977 through 1980. Plaintiff argues the statute was tolled by a waiver of the federal statute of limitations on Plaintiff's federal income tax return for these years, citing MCL 208.97. The parties disagree as to the interpretation of § 85 of the Single Business Tax Act. Without going through all of this again on my own, the Court simply adopts the reasoning of Judge Harrison in *Armco, Inc. v State of Michigan*, Docket No. 84-9612 in the Court of Claims and rejects Defendant's position.

NOW, THEREFORE, IT IS ORDERED that Plaintiff's Motion for Summary Disposition pursuant to MCR 2.116(C)(8) is granted for the reason that Defendant has failed to state a valid defense to Plaintiff's Complaint and also pursuant to MCR 2.116(C)(10), for the reason that there is no genuine issue as to any material fact and Plaintiff is entitled to judgment as a matter of law, and

Exhibit 14—First Wisconsin

Plaintiff is entitled to judgment against the Defendant herein in the amount of $40,110, together with interest calculated in accordance with MCLA 208.97(3) and MCLA 205.30(3).

/s/ Carolyn Stell
Honorable Carolyn Stell, Circuit Judge and Judge of the Court of Claims

Approved as to form:

/s/ Curtis G. Beck
Curtis G. Beck (P10600)
Attorney for Defendant
Entered on this — day of November, 1987.

.....
Clerk of the Court of Claims

Exhibit 15—Magic Chef

STATE OF MICHIGAN
IN THE COURT OF CLAIMS

MAGIC CHEF, INC.

Plaintiff, Docket No. 86-10395-CM

v. HON. JAMES R. GIDDINGS

REVENUE DIVISION, DEPARTMENT OF TREASURY, STATE OF MICHIGAN,

Defendant.

Patrick R. Van Tiflin (P26119)
FOSTER, SWIFT, COLLINS & COEY, P.C.
Attorneys for Plaintiff
313 South Washington Square
Lansing, MI 48933
518/372-8050

Charles E. Liken (P16677)
Assistant Attorney General
Attorney for Defendant
First Floor, Treasury Building
Lansing, MI 48913
517/373-1142

ORDER AND JUDGMENT

At a session of said Court, held in the Circuit Courtrooms in City Hall, Lansing, Michigan, on the 15th day of December, 1987.

Exhibit 15—Magic Chef

PRESENT: HONORABLE JAMES R. GIDDINGS,
Circuit Judge, Presiding

This matter having come on for hearing on November 10, 1987 on Plaintiff's Motion for Summary Disposition of its Complaint For Refund of Single Business Taxes, based upon MCR 2.116(C)(9) on the ground that Defendant has failed to state a valid defense, and upon MCR 2.116(C) (10) on the ground that there is no genuine issue as to any material fact and Plaintiff is therefore entitled to judgment as a matter of law, and the court having reviewed Plaintiff's Motion, Affidavit and Supporting Brief, Defendant's Answers and Brief and Plaintiff's Reply Brief, and the court having heard the oral argument of counsel and being otherwise duly advised in the premises, the court hereby determines that 1987 Public Act 39 is not retroactively applicable to the Plaintiff's Complaint For Refund, the court specifically finding that Public Act 39 is more than a clarification of Section 69 of the Single Business Tax Act which it amended, but rather works a substantive change to the statute, and that giving Public Act 39 retroactive effect would adversely affect the substantial rights of the Plaintiff and for the further reason that giving retroactive effect to Public Act 39 would be contrary to the Separation of Powers clause of the Michigan Constitution which prohibits the Michigan Legislature from reversing the judicial interpretation of a statute once an appellate interpretation has been rendered, and the court hereby further determining that Plaintiff is entitled to Summary Disposition for the reason that there is no genuine issue as to any material fact, and the court specifically finds that the apportioned tax base resulting

Exhibit 15—Magic Chef

from the application of the three factor formula is not reflective of the Plaintiff's business activity in the State of Michigan and that the applicable standards for the relief requested by Plaintiff are contained in Section 69 of the Single Business Tax Act as originally enacted and interpreted and applied by the Michigan Court of Appeals in *Jones & Laughlin Steel Corporation v. Michigan Department of Treasury*, 145 Mich App 405, 377 NW2d 397 (1985), *lv den* 424 Mich 895 (1986), *mot for reconsid den* 424 Mich 895 (1986), and that the Defendant has failed to state a valid defense to the claim of the Plaintiff; NOW, THEREFORE, IT IS HEREBY

ORDERED, that Plaintiff's Motion for Summary Disposition under MCR 2.116(C)(9) is granted for the reason that Defendant has failed to state a valid defense and is also granted under MCR 2.116(C)(10) for the reason that there is no genuine issue as to any material fact and the Plaintiff is entitled to judgment as a matter of law against the Defendant in the amount of $153,013 together with interest thereon calculated in accordance with MCLA 208.97(3) and MCLA 205.30(3).

/s/ JAMES R. GIDDINGS
Honorable James R. Giddings,
Circuit Judge and Judge of the
Court of Claims

Entered on this 15th day of December, 1987.
By: /s/ Ann M. Baird
Clerk of the Court of Claims

Exhibit 16—Sara Lee

STATE OF MICHIGAN
IN THE COURT OF CLAIMS

SARA LEE CORPORATION,

Plaintiff, Docket No. 87-11143-CM

v. HONORABLE CAROLYN STELL

REVENUE DIVISION, DEPARTMENT OF TREASURY, STATE OF MICHIGAN,

Defendant.

Patrick R. Van Tiflin (P26119)
FOSTER, SWIFT, COLLINS & COEY, P.C.
Attorneys for Plaintiff
313 South Washington Square
Lansing, MI 48933
517/372-8050

Curtis G. Beck (P10600)
Assistant Attorney General
Attorney for Defendant
First Floor, Treasury Building
Lansing, MI 48913
517/373-1142

ORDER AND JUDGMENT

At a session of said Court, held in the Circuit Courtrooms in Town Center, Lansing Michigan, on the 17th day of December, 1987.

PRESENT: HONORABLE CAROLYN STELL,
Circuit Judge, Presiding

This matter having been noticed on for hearing before this Court on Wednesday, November 25, 1987, on Plaintiff's Motion for Summary Disposition of its Complaint for Refund of Single Business Tax, and the parties having stipulated to waiver of oral argument by stipulation filed with this court and the Court having reviewed the pleadings filed by the respective parties in support of and in opposition to Plaintiff's Motion, and the Court being otherwise duly advised in the premises, and the Court finding as follows:

Defendant has not contested the factual content of Plaintiff's motion or the affidavit in support of Plaintiff's motion. The Defendant's response is that first, *Jones and Laughlin* is not a correct interpretation of the original legislative intent and, two, that the use of the statutory three-factor formula does result in a fair reflection of Plaintiff's Michigan business activity.

With respect to the first argument, *Jones & Laughlin* may or may not be a correct interpretation, but it is the interpretation of the Michigan Court of Appeals which has been allowed to stand by the Michigan Supreme Court's refusal to hear the case. Therefore, it is the law that this Court must follow. *Jones and Laughlin* says that the proper test for invoking Section 69 is whether the taxpayer's Michigan tax base as derived from the application of the three-factor apportionment formula to its adjused tax base accurately reflects the extent of the taxpayer's business activity within the state.

Defendant's brief cites 1987 P.A. 39 which offers an expression of the original intent of the Legislature. P.A. 39 provides that specific elements such as income should not be separately examined unless it can be demonstrated that the business activity attributed to the taxpayer in the state is out of all proportion to the actual business transacted in the state and leads to a grossly distorted result. Plaintiff responds by arguing that Defendant did not plead this as an affirmative defense until its amended answer and affirmative defense dated October 23, 1987. The original answer was filed on or about May 18, 1987. Defendant did not obtain leave of court or stipulation by Plaintiff to the filing of its amended answer as required by MCR 2.118(2). Plaintiff therefore contends assertion of this defense is improper. The scheduling conference order was signed on August 31st, 1987 by this Court, and it set October 30th, 1987, as a deadline for amending pleadings. I would note that in fact, as is set forth in the scheduling conference order, that because of my experience with these two counsel and because we've had many of these cases together, counsel themselves established these deadlines which were acceptable to the Court. So this is not some kind of artificial deadline imposed upon counsel by the Court, and counsel did so on August 26, 1987. This statute had been signed on June 9th, 1987. Therefore, counsel were aware at the time they met of the availability of this defense.

The Court holds that 1987 Public Act 39 is improperly raised and would not consider it for that reason. However, ruling in the alternative so that, in the end, if a re-

viewing court should find it was not untimely and that the Court is wrong in refusing to consider Defendant's affirmative defense, the court will consider it under several other theories. First, it appears that 1987 Public Act 39 presents two significant constitutional problems. The first is the issue of retroactivity and the situation is such that, as Plaintiff's counsel has pointed out, the law was not really in a state of flux. It was in a state of the Department of Treasury disagreeing very strenuously with an appellate court decision. But it was not the kind of situation in which retroactivity normally is granted on the theory that everybody knew everything was up in the air and therefore they should have been prepared for whatever result came down.

Secondly, I think that it presents constitutional problems under the commerce clause as detailed by Plaintiff's counsel. So, I would disregard it because of those constitutional problems. However, in the alternative, should a reviewing court find there are no constitutional problems either with the application of it retroactively or with the impact this has on the US Commerce Clause, I would make findings on a factual basis, and I would note that when a motion is made under MCR 2.116(C)(10), that an affidavit or supporting documentary evidence is required. That requirement was met by Plaintiff, both by affidavit and by citing to specific paragraphs in the Defendant's Answer to Plaintiff's Complaint. MCR 2.116 (G)(4) requires that the opposing party cannot simply deny, but must respond either by affidavit or other means set forth in the rule, and in the event of a failure to do so, that judgment shall be granted in favor of the moving

party if it is appropriate. Here, in looking at the facts, Plaintiff is a Maryland business corporation with its principal office in Chicago. Its business activity in Michigan consists of the sale of a variety of consumer products to customers in Michigan. For the years in question, compensation paid by the Plaintiff and included in the tax base ranged from $226,788,537 to $410,399,363, and represented as a percentage of the tax base between 77 and 99 percent.

The apportionment formula factors for the Plaintiff ranged from .011580 to .014811, resulting in a tax base apportioned to Michigan ranging from $3,529,677 to $7,421,332. The apportioned compensation ranged from $3,511,471 to $5,784,092, while the actual compensation for each of the challenged years ranged from 1,381,635 to 2,852,392. It is easy to observe from the Plaintiff's affidavit that the apportioned compensation grossly exceeded the actual compensation, by a percentage of excess ranging from 103% to 154%.

The Court finds that the totality of these circumstances results in a grossly distorted result even under P.A. 39 and therefore summary disposition is appropriate.

Defendant also raises a statute of limitations defense with respect to tax year 1980. Plaintiff argues the statute was tolled by a waiver of the federal statute of limitations on Plaintiff's federal income tax return for these years, citing MCL 208.97. The parties disagree as to the interpretation of § 85 of the Single Business Tax Act. This Court adopts the reasoning of Judge Harrison in

Exhibit 16—Sara Lee

Armco, Inc. v State of Michigan, Docket No. 84-9612 in the Court of Claims and rejects Defendant's position.

NOW, THEREFORE, IT IS ORDERED that Plaintiff's Motion for Summary Disposition pursuant to MCR 2.116(C)(8) is granted for the reason that Defendant has failed to state a valid defense to Plaintiff's Complaint and also pursuant to MCR 2.116(C)(10), for the reason that there is no genuine issue as to any material fact and Plaintiff is entitled to judgment as a matter of law against the Defendant herein in the amount of $245,011, together with interest calculated in accordance with MCLA 208.97 (3) and MCLA 205.30(3).

/s/ CAROLYN STELL
Honorable Carolyn Stell, Circuit Judge
and Judge of the Court of Claims

Entered on this 17th day of December, 1987.

/s/ KAY L. HOUSEMAN
Clerk of the Court of Claims

Exhibit 17—Presto

STATE OF MICHIGAN
IN THE COURT OF CLAIMS

PRESTO PRODUCTS, INCORPORATED,

Plaintiff,

File No. 83-8827

v

HON. JAMES T. KALLMAN

REVENUE DIVISION, DEPARTMENT OF TREASURY, STATE OF MICHIGAN,

Defendant.

OPINION AND ORDER

The matter before the Court is an action filed by Plaintiff seeking a refund of single business taxes paid for 1978 through 1984. The facts are adequately set forth in the Stipulation of Facts filed by the parties and in an Affidavit filed by Plaintiff.

Plaintiff's claim for refund is based on § 69 of the Single Business Tax Act (hereinafter "the Act") as interpreted by the Michigan Court of Appeals in *Jones & Laughlin Steel Corp v Michigan Dep't of Treasury*, 145 Mich App 405; 337 NW2d 397 (1985), *lv to app den*, 424 Mich 895 (March 18, 1986), *mot for reconsid den*, 424 Mich 895 (October 22, 1986). Defendant contends, however, that *Jones & Laughlin ("J&L")* is not a correct interpretation of the original legislative intent in enacting § 69 of the Act. Defendant claims that 1987 PA 39, effective June 9, 1987, expresses the original legislative intent and applies to Plaintiff's claim for refund. This Court does not agree. 1987 PA 39 is not retroactively applicable to

Plaintiff's claim for refund for the tax years in issue for the reasons advanced by Plaintiff in its brief to this Court. This conclusion is consistent with this Court's holding in *Digital Equipment Corp v Michigan Dep't of Treasury*, Court of Claims Docket No. 86-10484-CM (Nov. 2, 1987), as well as Judge Brown's decision in *Consolidation Coal Company v Michigan Dep't of Treasury*, Court of Claims Docket No. 82-8407-CM (Aug. 27, 1987) and Judge Stell's ruling in *First Wisconsin Financial Corp v Michigan Dep't of Treasury*, Court of Claims Docket No. 87-11132-CM (Nov. 25, 1987).

Since 1987 PA 39 is not retroactively applicable, § 69 of the Act as originally enacted and as interpreted by the Michigan Court of Appeals in *J&L* is the law to be applied in this case. *J&L* provides that the proper test for invoking § 69 is whether the apportionment provisions of the Act do not fairly represent the extent of the taxpayer's business activity in this state. A distortion of 50% in apportioned compensation over actual Michigan compensation justified relief in *J&L*. Applying the *J&L* analysis to the facts of this case, the Court finds that Plaintiff's business activity within the state is not fairly represented by the use of the statutory three factor apportionment formula. The distortion in Plaintiff's actual Michigan compensation which results from application of the Act's apportionment formula ranges from 705% in 1981, to infinite distortion in 1984 when Plaintiff paid no actual compensation in Michigan yet the statutory apportionment formula attributed $394,771 in compensation to the state. This unfair representation of Plaintiff's business activity in the state resulting from the use of statutory apportionment formula justifies the § 69 relief requested by Plaintiff.

Defendant further contends that Plaintiff's claim for 1978 and 1979 is barred by the four year statute of limitations in § 97 of the Act. Plaintiff responds that the statute of limitations is tolled pending a final determination of this litigation of its single business tax liability for those years as provided in § 85 of the Act. Defendant counters that the commencement of this litigation did not toll the statute of limitations because the complaint originally filed did not contain a claim for § 69 relief, and that litigation only tolls the running of the statute for claims involved in that litigation. In support of this contention, Defendant cites *National Bank of Detroit v Michigan Department of Treasury*, Court of Claims Docket No. 84-9603 (Sept. 20, 1985). However, the *NBD* decision has been reversed by the Michigan Court of Appeals in *National Bank of Detroit v Michigan Department of Treasury*, Court of Appeals Docket No. 88585 (Nov. 18, 1987). A request for publication of this decision is currently under advisement. In *NBD*, the Court of Appeals held that litigation on the single business tax return required by the Act tolled the period of limitations, even though the litigation in which NBD was initially involved concerned an unrelated single business tax issue. Therefore, despite the fact that the issue involved in this litigation as originally filed was unrelated to the claim for relief based of § 69 of the Act, the commencement of this litigation by Plaintiff nonetheless operated to toll the § 97 statute of limitations. Accordingly, this Court finds that Plaintiff's claim for refund for 1978 and 1979 is not barred by the Act's four year statute of limitations.

Finally, the Defendant contends that Plaintiff's request for relief under §69 is invalid for the reason that Plaintiff has failed to attack each element of the apportionment formula, citing *Donovan Construction Co. v Michigan Dep't of Treasury*, 126 Mich App 11; 337 NW2d 297 (1983), *lv den*, 419 Mich 894 (1984) and *Payne & Dolan of Wisconsin v Michigan Dep't of Treasury*, 138 Mich App 418; 360 NW2d 208 (1984). Defendant's reliance on *Donovan* and *Payne & Dolan* is misplaced. First of all, those cases involved the Michigan Income Tax Act not the Single Business Tax Act. Secondly, in those cases, the Defendant therein and herein sought to completely discard the statutory apportionment formula in favor of a separate accounting. The Court of Appeals held that the party seeking to deviate from the apportionment formula must attack each element of the apportionment formula and demonstrate that each factor of the formula sought to be discarded would be inappropriate to measure the taxpayer's business activity in the state. In the case at bar, Plaintiff does not seek to discard the Act's apportionment formula. In fact, Plaintiff seeks to retain the three factor formula in its entirety and utilize it to apportion all elements of its tax base except for compensation, which is grossly distorted when the apportionment formula is applied, and which has been precisely measured and can be directly allocated to the state. Therefore, because Plaintiff does not seek to completely discard the apportionment formula, the Court finds that Plaintiff need not attack each element of the apportionment formula in order to be entitled to the relief requested. Neither the Michigan Tax Tribunal, the Michigan Court of Appeals nor the

Michigan Supreme Court required that *J&L* attack each element of the formula and permitted precisely the modification of the apportionment formula sought by Plaintiff herein.

Based on Plaintiff's demonstration of the unfair representation of its business activity in the state of Michigan which results from the use of the apportionment formula contained in the Act, the Court finds that Plaintiff is entitled to directly allocate compensation and apportion the remainder of its tax base as prayed for in its First Amended Complaint. NOW, THEREFORE, IT IS

ORDERED, that Plaintiff is entitled to judgment against the Defendant in the amount of $42,584, together with interest calculated in accordance with MCLA 208.97(3).

/s/ James T. Kallman
Hon. James T. Kallman
Court of Claims Judge

Dated: December 22, 1987

STATE OF MICHIGAN
IN THE COURT OF CLAIMS

WM. WRIGLEY JR. COMPANY

Plaintiff,

v

OPINION AND ORDER

File No. 87-11013-CM

REVENUE DIVISION,
DEPARTMENT OF TREASURY,
STATE OF MICHIGAN,

Defendant.

Hon. James T. Kallman

This Court, having heard oral arguments of counsel, having reviewed the file and being fully advised in the premises makes the following determinations:

This matter is before the Court on plaintiff's motion for summary disposition on its complaint and for summary disposition of defendant's counterclaim. This Court is satisfied that plaintiff's motions should be granted.

Plaintiff has presented detailed authority and arguments in favor of its position. The Court adopts them as its own. Defendant's defense largely consists of criticizing *Jones and Laughlin v MDOT* 145 Mich App 405 (1985) lv den 424 Mich 895(1986). This Court is bound by *Jones*. Plaintiff is entitled to the relief requested. Plaintiff shall submit a judgment with the appropriate judgment fee for signature.

IT IS ORDERED, ADJUDGED AND DECREED that plaintiff's motion for summary disposition on its complaint is hereby GRANTED.

IT IS FURTHER ORDERED that plaintiff's motion for summary disposition of defendant's counterclaim is hereby GRANTED.

DATED: December 23, 1987

/s/ James T. Kallman
James T. Kallman
Court of Claims Judge

Exhibit 19—Blue Bell

STATE OF MICHIGAN

COURT OF CLAIMS

---/

BLUE BELL, INC.,

Plaintiff,

Docket No. 86-10620-CM

v

HON. MICHAEL G. HARRISON

REVENUE DIVISION,
DEPARTMENT OF TREASURY,
STATE OF MICHIGAN,

---/

Patrick R. Van Tiflin (P26119)
Attorney for Plaintiff
Foster, Swift, Collins & Coey, P.C.
313 S. Washington Square
Lansing, MI 48933
(517) 372-8050

Charles E. Liken (P16677)
Assistant Attorney General
Attorney for Defendant.

---/

ORDER AND JUDGMENT

At a session of said Court, held in the Circuit Courtrooms in City Hall, Lansing, Michigan on the 23rd day of December, 1987

PRESENT: HONORABLE MICHAEL G. HARRISON,
Chief Judge, Presiding

Exhibit 19—Blue Bell

This matter having come on for trial on Plaintiff's Complaint for Refund of Single Business Taxes relating to Plaintiff's fiscal years ended 9-30-81 through 9-30-85 and the Plaintiff having established that there is no genuine issue of material fact as to the relief requested in its Complaint or the Defendant's Counterclaim, the court hereby determines that Judgment should be rendered for the Plaintiff. This court is of the view that *Jones & Laughlin Steel Corporation v Michigan Department of Treasury* 145 Mich App 405, 337 NW2d 397 (1985), *lv den* 424 Mich 895 (1986), *mot for reconsid den* 424 Mich 895 (1986) states the law applicable to Plaintiff's Complaint which is binding on this court and which this court should apply to the facts of this case. The facts of this case indicate that the distortion resulting from the application of the three factor formula (279% - 433%) far exceeds that distortion which was present in *Jones & Laughlin* and justifies the relief requested. As a trial court, this court views its role as that of following the law as given to it by the appellate courts, and specifically in this case, by the Court of Appeals action and the Supreme Court inaction, in the *Jones & Laughlin* case. It is not within the power of this Court to decide that a decision of an appellate court which sits in review of this court is erroneous and to decline to follow an appellate court decision under those circumstances. On the contrary, this court determines that the facts in this case fall squarely within the holding of *Jones & Laughlin* and the trial court does not have the right to rule in any other fashion.

The Defendant urges that 1987 Public Act 39 applies to Plaintiff's Complaint for Refund and that Plaintiff

has no cause of action if Public Act 39 applies. This court is of the view that it should avoid a conflict with constitutional principles wherever possible in applying and interpreting the law, and specifically, this court feels no need to reach the question of the applicability of Public Act 39 to Plaintiff's Complaint for the reason that, even assuming that Public Act 39 applies to the Plaintiff's Complaint, this court is of the view that Section 3 is abridged in that the apportionment provisions of the Act, when applied to Plaintiff's tax base for the years involved, attribute business activity to Plaintiff in this state which is out of all appropriate proportion to the actual business transacted in this state and lead to a grossly distorted result.

Finally, this court is of the view that *Penn Mutual Life Insurance Company el at* [sic] *v Department of Licensing and Regulation, el at* [sic] 162 Mich App 123 (1987) is inapplicable to this case. This court is of the view that the appropriate time for Defendant to have argued for a prospective only application of the *Jones & Laughlin* decision was at the time that the *Jones & Laughlin* case was being presented since the *Jones & Laughlin* court itself did not give prospective only application to its decision, it is inappropriate for this court to do so in this case.

The Court therefore finds in favor of the Plaintiff for the relief requested in its Complaint, and in so doing, this Court incorporates the rationale for its decision in *Armco*, Court of Claims Docket No. 86-10689-CM and *Clevite*, Court of Claims Docket No. 86-10716-CM, NOW THEREFORE IT IS HEREBY

ORDERED, that the Plaintiff is hereby granted a Judgment in its favor and against the Defendant in the amount of $140,545 together with interest thereon calculated in accordance with MCL 208.97 and, IT IS HEREBY FURTHER

ORDERED, that Defendant's Counterclaim be and the same is hereby dismissed for the reason that employment of a single factor apportionment formula as suggested by Defendant's Counterclaim would result in more rather than less distortion and would be inappropriate in light of the facts of this case.

/s/ MICHAEL G. HARRISON
Honorable Michael G. Harrison
Chief Circuit Judge and Judge of
the Court of Claims

Approved as to form:
/s/ Charles E. Liken
Charles E. Liken (P16677)
Attorney for Defendant

Entered on this 23rd day of December, 1987.
/s/ PHYLLIS E. SMITH
Clerk of the Court

Exhibit 20—Sheller-Globe

STATE OF MICHIGAN
COURT OF CLAIMS

---/

SHELLER-GLOBE CORPORATION,

Plaintiff,

Docket No. 87-11073-CM

HONORABLE CAROLYN STELL

v

REVENUE DIVISION,
DEPARTMENT OF TREASURY,
STATE OF MICHIGAN,

Defendant.

---/

Patrick R. Van Tiflin (P26119)
FOSTER, SWIFT, COLLINS & COEY, P.C.
Attorneys for Plaintiff
313 S. Washington Square
Lansing, Michigan 48933
(517) 372-8050

Charles E. Liken (P16677)
Assistant Attorney General
Attorney for Defendant

---/

ORDER AND JUDGMENT

At a session of said Court held in the Circuit Courtrooms in Town Center, Lansing, Michigan, on the 4th day of January, 1988.

PRESENT: Honorable Carolyn Stell, Circuit Judge
Presiding

Exhibit 20—Sheller-Globe

This matter having come on for hearing before this Court on Wednesday, November 25, 1987, on Plaintiff's Motion for Summary Disposition of its Complaint for Refund of Single Business Tax and the Court having reviewed the pleadings filed by the respective parties in support of and in opposition to Plaintiff's Motion and the Court having conducted a hearing and heard the oral argument of counsel for the parties and being otherwise duly advised in the premises, the Court hereby determines that the Plaintiff has filed its Motion for Summary Disposition with a supporting Brief and an Affidavit as required by MCR 2.116(G)(3)(b) and the Defendant not having set forth specific facts by affidavit or as otherwise provided in that rule showing that there is a genuine issue for trial and the Court finding in the absence of such specific facts that judgment is appropriate under the rationale of *Jones & Laughlin Steel Corp v Michigan Dep't of Treasury*, 145 Mich App 405; 377 NW2d 397 (1985), *lv to app den*, 424 Mich 895 (March 18, 1986) *mot for reconsid den*, 424 Mich 895 (October 22, 1986) by which decision this Court considers itself to be bound; NOW, THEREFORE, IT IS

ORDERED, that Plaintiff's Motion for Summary Disposition be and the same hereby is granted in accordance with MCR 2.116(c)(10) for the reason that there is no genuine issue of material fact and the Plaintiff is entitled to judgment against the Defendant as a matter of law in the

amount of $859,717 together with interest calculated in accordance with MCLA 208.97(3).

/s/ Carolyn Stell
CAROLYN STELL, Circuit Judge
and Judge of the Court of Claims

/s/ JODY KRANZ
Clerk of the Court

STATE OF MICHIGAN
COURT OF CLAIMS

---/

USX CORPORATION (formerly
United States Steel Corporation),

Docket No. 86-10901-CM

v

HONORABLE THOMAS
L. BROWN

REVENUE DIVISION,
DEPARTMENT OF TREASURY,
STATE OF MICHIGAN.

---/

Patrick R. Van Tiflin (P26119)
Attorney for Plaintiff
Foster, Swift, Collins & Coey, P.C.
313 S. Washington Square
Lansing, Michigan 48933
(517) 372-8050

Charles E. Liken (P16677)
Assistant Attorney General
Attorney for Defendant

---/

ORDER AND JUDGMENT

At a session of said Court, held in the Circuit Courtrooms, in City Hall, in the City of Lansing, County of Ingham, State of Michigan, on the 21st day of Jan 1988.

PRESENT: Honorable Thomas L. Brown, Circuit Judge, Presiding

This matter having come on for hearing on January 6, 1988 on Plaintiff's Motion for Summary Disposition and

Exhibit 21—USX

the court having reviewed the Plaintiff's Motions, Briefs and Affidavit in support of said Motions and the Answers and Brief of the Defendant and the court having heard oral argument thereon and being otherwise duly advised in the premises, NOW, THEREFORE IT IS

ORDERED, that Plaintiff's Motion for Summary Disposition is granted as Defendant's asserted defense of 1987 Public Act 39 is not retroactively applicable to Plaintiff's claim for refund and because the result in this case is governed by § 69 of the Single Business Tax Act as originally enacted and as interpreted and applied by the Michigan Court of Appeals in *Jones & Laughlin Steel Corporation v Michigan Department of Treasury*, 145 Mich App 405, 377 NW2d 397 (1985), *lv den* 424 Mich 895 (1986), *mot for reconsid den* 424 Mich 895 (1986) and the prospective only concept of *Penn Mutual Life Insurance Company, et al v Department of Licensing and Regulation, et al*, 162 Mich App 123 (1987) is not applicable to the *Jones & Laughlin* decision and the Plaintiff is therefore entitled to Judgment in its favor and against the Defendant in the amount of $2,579,928 together with interest thereon calculated in accordance with MCLA 208.97 and MCLA 205.30.

Thomas L. Brown
Honorable Thomas L. Brown, Circuit Judge and Judge of the Court of Claims

Exhibit 21—USX

APPROVED AS TO FORM:

/s/ Charles E. Liken
Charles E. Liken (P16677)
Attorney for Defendant

Laurie Schoun
Clerk of the Court

Exhibit 22—Northern Telecom

STATE OF MICHIGAN
IN THE COURT OF CLAIMS

---/

NORTHERN TELECOM, INC.,

Plaintiff, Docket No. 86-10406-CM

v HONORABLE CAROLYN STELL

REVENUE DIVISION,
DEPARTMENT OF TREASURY,
STATE OF MICHIGAN.

Defendant.

---/

Patrick R. Van Tiflin (P26119)
FOSTER, SWIFT, COLLINS & COEY, P.C.
Attorneys for Plaintiff
313 South Washington Square
Lansing, MI 48933
517/372-8050

Russell E. Prins (P19110)
Assistant Attorney General
Attorney for Defendant
First Floor, Treasury Building
Lansing, MI 48922
(517) 373-1142

---/

ORDER AND JUDGMENT

At a session of said Court, held in the Circuit Courtrooms in Town Center, Lansing, Michigan, on the 23rd day of February, 1988.

Exhibit 22—Northern Telecom

PRESENT: HONORABLE CAROLYN STELL, Circuit Judge, Presiding

This matter having been set on for trial before this Court on Tuesday, February 23, 1988, and the parties having filed a Stipulation of Facts dated February 5, 1988 and the parties having stipulated to waiver of oral argument by stipulation filed with this court and the Court having reviewed the court file in this matter, and the Court being otherwise duly advised in the premises, and the Court finding as follows:

The facts are not contested. The Defendant's defense is that first, *Jones and Laughlin* is not a correct interpretation of the original legislative intent and, two, that the use of the statutory three-factor formula does result in a fair reflection of Plaintiff's Michigan business activity.

With respect to the first argument, *Jones & Laughlin* may or may not be a correct interpretation, but it is the interpretation of the Michigan Court of Appeals which has been allowed to stand by the Michigan Supreme Court's refusal to hear the case. Therefore, it is the law that this Court must follow. *Jones and Laughlin* says that the proper test for invoking Section 69 is whether the taxpayer's Michigan tax base as derived from the application of the three-factor apportionment formula to its adjusted tax base accurately reflects the extent of the taxpayer's business activity within the state.

Defendant's brief cites 1987 P.A. 39 which offers an expression of the original intent of the Legislature. P.A. 39 provides that specific elements such as income should

not be separately examined unless it can be demonstrated that the business activity attributed to the taxpayer in the state is out of all proportion to the actual business transacted in the state and leads to a grossly distorted result. It appears that 1987 Public Act 39 presents two significant constitutional problems. The first is the issue of retroactivity and the situation is such that, as Plaintiff's counsel has pointed out, the law was not really in a state of flux. It was in a state of the Department of Treasury disagreeing very strenuously with an appellate court decision. But it was not the kind of situation in which retroactivity normally is granted on the theory that everybody knew everything was up in the air and therefore they should have been prepared for whatever result came down.

Secondly, I think that it presents constitutional problems under the commerce clause as detailed by Plaintiff's counsel. So, I would disregard it because of those constitutional problems. However, in the alternative, should a reviewing court find there are no constitutional problems either with the application of it retroactively or with the impact this has on the US Commerce Clause, I would make findings on a factual basis. Here, in looking at the facts, Plaintiff is a Delaware business corporation with its principal office in Nashville, Tennessee. Its business activity in Michigan consists of the operation of manufacturing facilities and sales offices. For the years in question, compensation paid by the Plaintiff and included in the tax base ranged from $35,390,261 to $173,300,422, and represented as a percentage of the tax base between 70 and 100 percent.

The apportionment formula factors for the Plaintiff ranged from .004189 to .015614, resulting in a tax base apportioned to Michigan ranging from $428,761 to $2,007,968. The apportioned compensation ranged from $355,677 to $1,621,225, while the actual compensation for each of the challenged years ranged from $42,747 to $185,951. It is easy to observe from the Plaintiff's affidavit that the apportioned compensation grossly exceeded the actual compensation, by a percentage of excess ranging from 396% to 772%.

The Court finds that the totality of these circumstances results in a grossly distorted result even under P.A. 39 and therefore Judgment in favor of Plaintiff is appropriate.

Defendant also raises a statute of limitations defense with respect to years 1977 through 1979. Plaintiff argues the statute was tolled by a waiver of the federal statute of limitations on Plaintiff's federal income tax return for these years, citing MCL 208.97. The parties disagree as to the interpretation of § 85 of the Single Business Tax Act. This Court incorporates by reference its decision in *E. I. du Pont de Nemours and Company v. Michigan Department of Treasury*, Court of Claims Docket No. 86-10381-CM, to the effect that waiver of the statute of limitations on Plaintiff's Federal Income Tax return tolls the running of the Single Business Tax Statute of Limitations on refund claims. NOW, THEREFORE, IT IS

ORDERED, that Plaintiff is entitled to judgment as a matter of law against the Defendant herein in the

amount of $46,263, together with interest calculated in accordance with MCLA 208.97(3) and MCLA 205.30(3).

Carolyn Stell
Honorable Carolyn Stell, Circuit Judge and Judge of the Court of Claims

APPROVED AS TO FORM:

/s/ Russell E. Prins
Russell E. Prins (P19110)
Entered on this 23 day of February, 1988.

Jenean K. Battin
Clerk of the Court of Claims

TABLE 4

Business Sector	Components of Michigan Tax Base: Compensation	% of Column Total	% of Row Total	Business Income	% of Column Total	% of Row Total	Additions	% of Column Total	% of Row Total	Subtractions	% of Column Total
Agriculture	$ 126,915,987	0.3	72.1	$ (12,602,299)	(0.4)	(7.2)	$ 71,541,657	0.5	40.6	$ 9,750,533	0.
Mining	219,365,723	0.5	54.6	27,191,969	0.8	6.8	239,722,259	1.7	59.6	84,125,928	2.
Construction	2,131,773,502	4.6	82.5	101,594,020	3.0	3.9	430,399,492	3.1	16.6	78,440,286	2.
Other Durable Manufacturers	3,100,868,105	6.7	77.7	438,663,253	12.8	11.0	638,386,173	4.5	16.0	189,180,129	5.
Non-Durable Manufacturers	3,269,995,332	7.0	66.1	1,003,399,373	29.3	20.3	1,087,689,629	7.7	22.0	411,974,561	11.
Primary Metal Industries	1,353,854,985	2.9	81.7	91,085,053	2.7	5.5	279,344,412	2.0	16.9	66,688,017	1.
Fabricated Metal Products	1,480,260,507	3.2	80.0	171,215,354	5.0	9.3	270,195,376	1.9	14.6	72,247,040	2.
Machinery-Except Electrical	2,201,178,290	4.7	77.7	329,437,362	9.6	11.6	444,475,451	3.2	15.7	141,072,457	4.
Transportation Equipment	10,533,916,766	22.7	94.8	(1,093,328,495)	(32.0)	(9.8)	2,163,536,438	15.3	19.5	497,675,853	14.
Transportation	1,551,436,364	3.3	85.8	(118,151,923)	(3.5)	(6.5)	403,501,511	2.9	22.3	28,858,069	0.
Communications & Utilities	1,392,738,487	3.0	51.4	(20,903,441)	(0.6)	(0.8)	1,385,788,927	9.8	51.1	45,514,715	1.
Wholesale Trade	1,510,291,140	3.3	68.6	442,610,720	12.9	20.1	432,287,622	3.1	19.6	183,159,575	5.
Retail Trade	9,574,169,664	20.6	79.2	890,310,451	26.0	7.4	2,185,508,334	15.5	18.1	555,462,675	16.
Finance Insurance, Real Estate	1,703,262,006	3.7	59.6	(52,666,508)	(1.5)	(1.8)	1,978,897,904	14.0	69.3	773,528,859	22.
Services and Other	6,246,280,456	13.5	67.6	1,222,578,432	35.7	13.2	2,097,690,493	14.9	22.7	330,546,763	9.
All Businesses	$46,336,507,314	100.0	76.7	$3,429,433,321	99.8	5.7	$14,108,965,678	100.1	23.3	$3,468,225,460	100.

Exhibit 23 Analysis of the Michigan Single Business Tax

TABLE 4

Components of Michigan Tax Base

Compensation	% of Column Total	% of Row Total	Business Income	% of Column Total	% of Row Total	Additions	% of Column Total	% of Row Total	Subtractions	% of Column Total	% of Row Total	Total	% of Column Total	% of Row Total
$ 136,915,987	0.3	72.1	$ (12,602,299)	(0.4)	(7.2)	$ 71,541,657	0.5	40.6	$ 9,750,533	0.3	(5.5)	$ 176,106,812	0.3	100.0
219,765,723	0.5	54.6	27,191,969	0.8	6.8	239,722,259	1.7	59.6	84,125,928	2.4	(20.9)	402,354,023	0.7	100.1
2,131,773,542	4.6	82.5	101,596,020	3.0	3.9	430,399,492	3.1	16.6	78,440,286	2.3	(3.0)	2,585,326,728	4.3	100.0
3,100,963,105	6.7	77.7	438,663,253	12.8	11.0	638,386,173	4.5	16.0	189,180,129	5.5	(4.7)	3,988,737,402	6.6	100.0
3,209,995,332	7.0	66.1	1,033,399,373	29.3	20.3	1,087,689,629	7.7	22.0	411,974,561	11.9	(8.3)	4,949,109,773	8.2	100.1
1,353,354,985	2.9	81.7	91,985,053	2.7	5.5	279,344,412	2.0	16.9	66,688,017	1.9	(4.0)	1,657,596,433	2.7	100.1
1,480,200,507	3.2	80.0	171,215,356	5.0	9.3	270,195,376	1.9	14.6	72,247,040	2.1	(3.9)	1,849,424,197	3.1	100.0
2,301,129,290	4.7	77.7	329,437,862	9.6	11.6	444,475,451	3.2	15.7	141,072,457	4.1	(5.0)	2,834,018,646	4.7	100.0
10,533,916,766	22.7	96.8	(1,093,328,495)	(32.0)	(9.8)	2,163,536,438	15.3	19.5	497,675,853	14.3	(4.5)	11,106,448,856	18.4	100.0
1,551,436,366	3.3	85.8	(118,151,923)	(3.5)	(6.5)	403,501,511	2.9	22.3	28,858,069	0.8	(1.6)	1,807,927,883	3.0	100.0
1,892,783,487	3.0	51.4	(30,903,441)	(0.6)	(0.8)	1,885,788,927	9.8	51.1	45,514,715	1.3	(1.7)	2,712,109,258	4.5	100.0
1,510,291,140	3.3	68.6	442,610,739	12.9	20.1	432,287,622	3.1	19.6	183,159,575	5.3	(8.3)	2,202,029,907	3.6	100.0
9,574,169,666	20.6	79.2	893,310,451	26.0	7.4	2,185,508,336	15.5	18.1	555,462,675	16.0	(4.6)	12,096,525,774	20.0	100.1
1,703,262,006	3.7	59.6	(52,666,498)	(1.5)	(1.8)	1,978,807,906	14.0	69.3	773,528,859	22.3	(27.1)	2,855,966,543	4.7	100.0
6,246,280,456	13.5	67.6	1,222,588,432	35.7	13.2	2,997,660,493	14.9	22.7	330,546,763	9.5	(3.6)	9,236,002,618	15.3	99.9
$46,336,907,334	100.0	76.7	$3,430,433,321	99.8	5.7	$14,108,965,638	100.1	23.3	$3,468,225,460	100.0	(5.7)	$60,457,680,853	100.1	100.0

EXHIBIT 23

Exhibit 24—Single Business Tax Calculation

Tax Base		Average Apportionment Percentage					
(major components are federal taxable income, compensation, depreciation, interest, royalties and dividends)	x	factors are sales, property, and payroll (not the same as compensation component in tax base)	=	Apportioned Tax Base*	x	Tax Rate	= Tax Liability

* Capital acquisition adjustments are allowed to apportioned tax base, but are not revelant to this case.

Exhibit 25—UDITPA Prefatory Note

UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT

Prefatory Note

The Uniform Division of Income for Tax Purposes Act is designed for enactment in those states which levy taxes on or measured by net income.

The need for a uniform method of division of income for tax purposes among the several taxing jurisdictions has been recognized for many years and has long been recommended by the Council of State Governments. There is no other practical means of assuring that a taxpayer is not taxed on more than its net income. At present there are various formulae for determining the amount of income to be taxed in use by the states, and the differences in the formulae produce inequitable results. Many states now use the three factor formulae of this Act. The problem has been well analyzed and its historical background outlined in an article appearing in 18 Ohio State Law Journal, page 84.

The Uniform Division of Income for Tax Purposes Act is the result of conferences with the representatives of the Controller's Institute of America, the Council of State Governments and various interested individuals. It was promulgated in 1957. The comments in the present reprinting of the Act were revised and extended in February 1966 in order to clarify the solutions to some of the problems which have been experienced in securing enactment of the Act in the several states.

March 1, 1966

Exhibit 26—UDITPA § 18 and Editorial Comment

Section 18. If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) separate accounting;

(b) the exclusion of any one or more of the factors;

(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Comment

It is anticipated that this Act will be made a part of the income tax acts of the several states. For that reason, this section does not spell out the procedure to be followed in the event of a disagreement between the taxpayer and the tax administrator. The income tax acts of each state presumably outline the procedure to be followed.

Section 18 is intended as a broad authority, within the principle of apportioning business income fairly among the states which have contact with the income, to the tax administrator to vary the apportionment formula and to vary the system of allocation where the provisions of the Act do not fairly represent the extent of the taxpayer's business activity in the state. The phrases in

section 18(d) do not foreclose the use of one method for some business activity and a different method for a different business activity. Neither does the phrase "method" limit the administrator to substituting factors in the formula. The phrase means any other method of fairly representing the extent of the taxpayer's business activity in the state.

BEST AVAILABLE COPY

[redacted],

Petitioner,

v.

[redacted] OF MICHIGAN,

Respondent.

On Writ of Certiorari to the Michigan Supreme Court

[redacted]
[redacted] OF STATE GOVERNMENTS,
[redacted] OF MAYORS,
[redacted] STATE LEGISLATURES,
[redacted],
[redacted],
[redacted] AND
[redacted] ASSESSMENT ASSOCIATION;
[redacted] TAX COMMISSION
AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

[redacted] RUTH SOLOMON *
Chief Counsel
[redacted]
[redacted] LEGAL CENTER
[redacted] North Capitol Street, N.W.
Suite [redacted]
Washington, D.C. 20001
([redacted]) [redacted]

* *Counsel of Record for the Amici Curiae*

[redacted] - [redacted] - [redacted] - [redacted]

QUESTION PRESENTED

Whether Michigan's Single Business Tax, Mich. Comp. Laws § 208.1 *et seq.*, is consistent with the Commerce and Due Process Clauses of the federal Constitution.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

No. 89-1106

TRINOVA CORPORATION,

Petitioner,

v.

STATE OF MICHIGAN,

Respondent.

On Writ of Certiorari to the Michigan Supreme Court

BRIEF OF THE COUNCIL OF STATE GOVERNMENTS, U.S. CONFERENCE OF MAYORS, NATIONAL CONFERENCE OF STATE LEGISLATURES, NATIONAL LEAGUE OF CITIES, NATIONAL GOVERNORS' ASSOCIATION, NATIONAL ASSOCIATION OF COUNTIES, AND INTERNATIONAL CITY MANAGEMENT ASSOCIATION; JOINED BY THE MULTISTATE TAX COMMISSION AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

INTEREST OF THE *AMICI CURIAE*

Amici Council of State Governments, U.S. Conference of Mayors, National Conference of State Legislatures, National League of Cities, National Governors' Association, National Association of Counties, and International City Management Association are organizations whose members include state, county, and municipal governments and officials throughout the United States; they have a compelling interest in legal issues that affect state and local governments. *Amicus* Multistate Tax Commission is the official administrative agency of the Multistate

Tax Compact.[1] The Commission has a vital and continuing interest in tax disputes that may affect the administration of state tax systems.

This case involves a constitutional challenge to Michigan's Single Business Tax, the State's principal levy on business. Petitioner's argument calls into question methods that now are used by virtually all States to apportion the values of interstate businesses for purposes of state taxation; it also, at a time that many States are facing severe budget problems, challenges an innovative system of taxation that encourages investment and produces stable revenues. *Amici* therefore submits this brief to assist the Court in the resolution of this case.[2]

STATEMENT

1. Michigan's principal tax on business is a Single Business Tax (SBT), Mich. Comp. Laws (MCL) § 208.1 *et seq.*, that it imposes on all "business activity in [Michigan] which is allocated or apportioned to [Michigan]." MCL § 208.31(1). This taxable "business activity" is broadly defined to include the "transfer of legal or equitable title to or rental of property, * * * or the performance of services, or a combination thereof." MCL § 208.3(2). As interpreted by the Michigan Supreme Court, "[t]he subject of the [SBT] thus encompasses the complete range of entrepreneurial activities of which compensating employees is but one part." Pet. App. 22a.

Calculation of the value of this taxable "business activity" begins with federal taxable income. MCL §§ 208.3(3), 208.9. See Pet. App. 11a; *Mobil Oil Corp. v. Department of Treasury*, 373 N.W.2d 730, 732, 741-742 n.15

[1] The Compact has been entered into by 18 States and the District of Columbia as full members; 12 additional States have joined the Compact as associate members. This brief should not be read to reflect the views of any member State that files a separate brief in this case.

[2] The parties' letters of consent pursuant to Rule 37 of the Rules of this Court have been filed with the Clerk of the Court.

(Mich. 1985). To this figure the taxpayer makes several additions that "reflect the business consumption of labor and capital" (Pet. App. 11a), including "compensation, depreciation, dividends, and interest *paid* by the taxpayer to the extent deducted from federal taxable income." *Ibid.* See MCL §§ 208.9(2)-(6). If the taxpayer is a multistate business, it then determines the portion of this business activity that is taxable in Michigan. It does so by attributing to Michigan the percentage of the firm's tax base (that is, the portion of its business activity) that is equivalent to the percentage of the firm's total business activity that it conducts in Michigan, as calculated by use of a three-part formula that itself is the average of three ratios: the ratio of the firm's in-state sales to its total sales; the ratio of its in-state property to its total property; and the ratio of its in-state payroll to its total payroll. MCL § 208.45. See Pet. App. 11a-12a.[3] Once apportioned (and as modified by certain adjustments not at issue here), the tax base is multiplied by the SBT tax rate of 2.35% to determine the taxpayer's liability. MCL § 208.31(1). See Pet. App. 13a.

2. Petitioner is an Ohio corporation that manufactures automobile components. Although most of its manufacturing takes place elsewhere, petitioner has fourteen sales and clerical personnel in Michigan. In 1980, the tax year at issue here, petitioner also made some 26.6% of its sales—worth $103,981,354—in the State. Pet. App. 7a.

For the year in question, petitioner had a total tax base of $221,125,319. Pet. App. 11a n.10. Using the SBT's three-part formula, petitioner concluded that just under 9% of this base, or $19,838,700 should be attributed to Michigan. *Id.* at 12a-13a n.12. Petitioner then was permitted to reduce this figure to $12,492,671 through application of a so-called excess compensation deduction

[3] The apportionment formula is taken from the Uniform Division of Income for Tax Purposes Act (UDITPA), 7A U.L.A. 322. See Pet. App. 12a n.12.

(the details of which have no bearing on the constitutional issues now before the Court). *Id.* at 13a n.13. Petitioner owed $293,528 on this amount, which it paid. *Id.* at 7a.

Petitioner subsequently brought this suit, seeking a refund and challenging the constitutionality of the SBT apportionment formula under the Commerce and Due Process Clauses. Pet. App. 7a-8a, 20a-21a. While petitioner acknowledged that the business income (or loss) portion of the tax base was subject to formulary apportionment, it contended that the three-part formula could not be applied to the compensation and depreciation elements of the tax base. Instead, petitioner argued that Michigan could tax only "actual" Michigan compensation and depreciation. See *id.* at 24a. Because petitioner's actual Michigan compensation was $511,774 and its actual Michigan depreciation was $2,152—and because petitioner had a substantial business *loss* for the year in question—it concluded that it had a negative tax base and accordingly had *no* tax liability. See *id.* at 8a & n.4. The Michigan Court of Claims accepted petitioner's contention (*id.* at 42a-51a), but the Michigan Court of Appeals reversed. *Id.* at 30a-41a.

The Michigan Supreme Court affirmed that judgment, sustaining the constitutionality of the SBT's apportionment provision. Pet. App. 1a-28a.[4] The court noted that this Court "long ago upheld the constitutionality of formulary apportionment" (*id.* at 23a), "reject[ing] separate accounting as a means to identify business activity by reference to a discrete geographic boundary." *Id.* at 22a. The court added that it did "not believe that

[4] Petitioner had brought suit under MCL § 208.69, which authorized relief when the statutory apportionment formula failed fairly to reflect the extent of the taxpayer's business activity in Michigan. See Pet. App. 5a-9a, 13a-14a. The court concluded that relief was available under Section 208.69 only when failure to modify the formula would result in a constitutional violation. Pet. App. 16a-17a. The court went on to find no such violation here. Section 208.69 has since been amended. See page 13, *infra*.

'business activity' as defined under the act is susceptible to accurate analysis when only one component of the total business effort is examined." *Id.* at 23a. Noting the enormous volume of petitioner's sales in Michigan (*id.* at 24a), the court concluded that "the averaged ratios of Trinova's payroll, property, and sales 'actually reflect a reasonable sense of how [its Michigan business activity was] generated,' clearly satisfying the constitutional requirements of internal and external consistency." *Id.* at 25a (bracketed material added by the court).

SUMMARY OF ARGUMENT

A. Petitioner concedes, as it must, that this Court repeatedly has upheld use of the three-part apportionment formula in dividing *income* for purposes of state taxation. Its attempt to avoid the force of these holdings rests on three propositions: that the SBT is a tax on segregable increments of "value added"; that these increments of value (in contrast with concededly apportionable income) are readily capable of precise territorial allocation; and that the use of sales ratios in the apportionment formula is in any event inappropriate because sales activity is irrelevant to the determination of a value added tax. Each of these propositions is incorrect. Petitioner mischaracterizes the SBT, and petitioner's economic assumptions are inconsistent with this Court's holdings.

1. At the outset, it is clear that the SBT was not intended to tax individual increments of value. It reaches all of a firm's "business activity," a term that is defined to include sales. And the incidence of the tax—the "business activity" upon which it is imposed—expressly was understood by the legislature to be a unitary and indivisible course of conduct commencing with a firm's purchase of raw materials and ending with its sale of the manufactured product. The theory of the tax therefore is that a firm cannot identify the "value added" by isolated elements of its activity, a theory that makes formulary apportionment unavoidable.

2. Petitioner contends that the taxed activity is not unitary because the costs of production (which petitioner equates with the "value added") can be localized. But that assertion is inconsistent with the analysis that this Court traditionally has used to decide tax apportionment cases. The same factors that make it impossible to tie the generation of income to a particular location—centralization of management and purchasing, economies of scale, functional integration, and so on—also frustrate attempts to compartmentalize the costs associated with particular elements of business activity. In this case, for example, the existence of a large market for petitioner's goods in Michigan necessarily affected the efficiency with which petitioner was able to make use of its labor and capital further up the production chain; it hardly is necessary to prove that an effective marketing operation is important to assure full use of production facilities.

3. Similar problems inhere in petitioner's argument that sales activity is irrelevant to the concept of value added. Sales are prerequisites to the effective use of manufacturing and a labor force; in fact, the Court has approved the use of sales ratios in apportionment precisely because they reflect a share of the activities by which value is generated. And since the services that Michigan provides to petitioner and its customers make possible petitioner's continuing business operations, there is nothing unfair in the State's seeking to tax a share of the values generated by those operations. Against this background, it is not surprising that the Court *already* has upheld use of the familiar three-part formula to apportion a tax that was virtually identical to the SBT. *Armco Steel Corp. v. Department of Revenue*, 102 N.W.2d 552 (Mich.), app. dismissed, 364 U.S. 337 (1960).

Indeed, invalidating the SBT would be an exercise in the most wooden formalism because—as petitioner concedes—the tax would be immune from constitutional attack were it simply labeled a levy on gross receipts. And the artificiality of petitioner's argument is especially ap-

parent because value added taxes almost universally are understood to be, in practical operation, a form of sales tax. The label placed on the tax cannot change the nature of the economic values reflected in the tax base.

B. Petitioner also argues that the SBT discriminates against out-of-state businesses because, through use of a sales factor in the apportionment formula, it taxes "site-specific" out-of-state values while not taxing "site-specific" in-state values. But this claim rests entirely on petitioner's prior assertions that the costs of production are, in fact, "site specific," and that sales have no relationship to value added. Once it is understood that Michigan imposes the SBT on a unitary course of business activity that includes both production and sales, it is evident that out-of-state firms have no ground to complain because values are transferred neither into nor out of the State.

ARGUMENT

I. THE SBT IS FAIRLY APPORTIONED AND THEREFORE IS CONSISTENT WITH THE COMMERCE AND DUE PROCESS CLAUSES.

The principles that control the resolution of this case have become familiar. States may, of course, tax enterprises that operate in interstate commerce, so long as they do so within the parallel constraints set by the Commerce and Due Process Clauses. In relevant part,[5] those

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[5] Under the now-familiar test first set out in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), the Court will "sustain[] a state tax 'against Commerce Clause challenge when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.'" *Amerada Hess Corp. v. New Jersey Taxation Division*, 109 S.Ct. 1617, 1621 (1989), quoting *Complete Auto*, 430 U.S. at 279. The Court also has made clear that "the *Complete Auto* test encompasses due process standards." *Amerada Hess*, 109 S.Ct. at 1625. In this case, petitioner concedes the existence both of nexus and of a fair relationship between the tax and the services provided by the State; its principal challenge is to the apportionment prong

provisions require that any state tax be "'fairly apportioned'" (*Amerada Hess Corp. v. New Jersey Taxation Division*, 109 S.Ct. 1617, 1621 (1989), quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)) so that there is "a rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 436-437 (1980). See *Exxon Corp. v. Department of Revenue*, 447 U.S. 207, 219 (1980); *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 272-273 (1978). As a result, a valid "tax cannot be 'out of all appropriate proportion to the business transacted by the [taxpayer] in that State.'" *Exxon Corp.*, 447 U.S. at 220 (citation omitted). At the same time, however, "[a] state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940).

The Court also has made clear that, when the tax base of a multistate enterprise "bears relation to benefits and privileges conferred by several States[,] * * * apportionment is ordinarily the accepted method" of determining the share of multistate values subject to taxation by a single State. *Mobil Oil Corp.*, 445 U.S. at 446. This typically is accomplished through use of a formula that attributes to the taxing State a percentage of the multistate firm's tax base (in most States, net income) that is equivalent to the percentage of the firm's total business activity conducted in that State. This latter proportion may be calculated by taking the ratio of the firm's in-state sales to its total sales,[6] the ratio of its in-state property

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of the *Complete Auto* test. Petitioner also asserts that the SBT is discriminatory, a contention we discuss below.

[6] See, *e.g.*, *Moorman*, 437 U.S. at 273-275.

to its total property,[7] the ratio of its in-state payroll to its total payroll—or, as is true in Michigan (and in most other states), by taking the average of these three proportions. Needless to say, the Court's approval of these formulary apportionment methods means that, "[a]s this Court has on several occasions recognized, a company's internal accounting techniques are not binding on a State for tax purposes." *Exxon Corp.*, 447 U.S. at 221.

In particular, when an enterprise is "unitary"—that is, when its multistate activities are interconnected with one another—the Court has refused to limit taxation of the firm's income to the State in which separate accounting shows that the income was produced. As the Court has noted:

> apportionability often has been challenged by the contention that income earned in one State may not be taxed in another if the source of the income may be ascertained by separate geographical accounting. The Court has rejected that contention so long as the interstate and extrastate activities formed part of a single unitary business. * * * In these circumstances, the Court has noted that separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. * * * Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source."

Mobil Oil Corp., 445 U.S. at 438. See *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 181 (1983); *Exxon Corp.*, 447 U.S. at 222-223; *Butler Brothers v. McColgan*, 315 U.S. 501, 508 (1942); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 282-283 (1924);

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[7] See, *e.g.*, *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 120-121 (1920).

Where unitary firms are involved, the Court accordingly has permitted States to use virtually any rational approach in apportioning the tax base. And the three-factor apportionment formula used by Michigan "'has become something * * * of a benchmark against which other apportionment formulas are judged.'" *Amerada Hess*, 109 S.Ct. at 1621-1622, quoting *Container Corp.*, 463 U.S. at 170. That formula "has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated." *Container Corp.*, 463 U.S. at 183.

Petitioner acknowledges the force of these governing principles (Br. 23-24), and evidently recognizes that it is a unitary business of the sort whose tax base ordinarily is subject to formulary apportionment. See Pet. App. 17a n.18. But petitioner nevertheless insists that Michigan may not use the three-part formula in identifying the values that are taxable in-state under the SBT. Petitioner's attempt to escape the force of this Court's decisions approving use of formulary apportionment rests on three propositions: that the SBT is a tax on segregable increments of "value added" by a multistate business (Br. 25); that these increments of value (in contrast, according to petitioner, with concededly apportionable income or profit) "are readily capable of precise territorial allocation both in theory and practice" (Br. 25); and that use of sales ratios in the apportionment formula is in any event inappropriate because "sales, in and of themselves, have no proper independent function in the determination of a value added tax" (Br. 34). In our view, however, each of these propositions is demonstrably incorrect: petitioner's description of the SBT is simply inaccurate, and its economic assumptions are flatly inconsistent with the teachings of this Court.

A. The SBT Is A Tax On The Unitary Course Of Business Activity.

At the outset, petitioner fundamentally misdirects what should be the proper inquiry here. Its arguments are aimed at a sort of imaginary, theoretical value added tax (VAT) that is imposed on individual increments of value, that "is based on the origin principle of taxing value where it is added" (Br. 25), and that entirely disregards sales activity. But that tax is, very simply, not the Michigan SBT. While the SBT is, of course, "a form of value added tax" (Pet. App. 9a-10a), Michigan's levy in terms is imposed on all of a firm's "business activity in [Michigan] which is allocated or apportioned to [Michigan]." MCL § 208.31(1). And the incidence of this tax—the "business activity" upon which it is imposed—was understood by the legislature to be a unitary and indivisible course of conduct commencing with a firm's purchase of raw materials and ending with its sale of the manufactured product.

The SBT accordingly defines taxable "business activity" as broadly including any "transfer of legal or equitable title to or rental of property, whether real, personal, or mixed, tangible or intangible, or the performance of services, or a combination thereof." MCL § 208.3(2). This definition, of course, specifically includes sales activity.[8] As the court below explained, in an interpretation of state law that is conclusive here, "[t]he subject of the [SBT] thus encompasses the complete range of entrepreneurial activities of which compensating employees is but one part." Pet. App. 22a.[9] See *id.* at 18a.

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[8] As petitioner recognizes (Br. 33 n.24), the SBT treats a sale as having occurred in Michigan whenever a product is shipped to a purchaser in the State, "regardless of the free on board point or other conditions of the sales." MCL § 208.52(a). See Pet. App. 24a-25a n.25. Granting the existence of nexus to tax, petitioner does not—and plainly could not—find anything unconstitutional in this provision.

[9] Petitioner's statement (Br. 25) that the SBT "is based on the origin principle of taxing value where it is added" is nonsensical. As commonly used in the VAT setting, the term "origin principle"

Indeed, while petitioner evidently finds it significant that the SBT makes use of the addition method of computation (Br. 37),[10] the Michigan Legislature has made

simply means that the tax is imposed at the point of production; the term "destination principle" means that the tax is imposed at the point of consumption. See, *e.g.*, 3 U.S. Dep't of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth* 11-12 (1984) (hereinafter cited as "3 *Tax Reform*") ("If a product is taxed where it is produced, it is said to be taxed on the basis of its origin or place of production. Alternatively, if a product is taxed where it is consumed, it is taxed on the basis of its destination or location of consumption."). These concepts have relevance in the context of international trade (see *id.* at 11-13); it is not at all clear that they are meaningful in discussing the SBT, which is an apportioned tax on all business activity, from production through sale. But insofar as petitioner's business is concerned, it is plain that the SBT was intended to reach the properly apportioned part of all unitary values associated with the production and sale of its products in Michigan, and in that sense is imposed at the point of consumption.

[10] As petitioner seems to acknowledge (Br. 5) and as economists universally recognize, the method of calculation—whether addition of costs or subtraction of expenses—is irrelevant to the nature of the tax because the two methods will produce identical tax bases; "the result of the subtraction is identical with the sum of the addition." Smith, *Value-added tax: the case for*, Harv. Bus. Rev. 77, 78 (Nov.-Dec. 1970). See, *e.g.*, American Bar Ass'n, *The Choice Between Value Added and Sales Taxation at the Federal and State Levels in the United States*, Fourth Report of the Special Comm. on the Value-Added Tax of the Section on Taxation, 29 Tax. Law. 457, 458-459 (1976) ("The addition method reaches the same result [as the subtraction method] by the opposite means."); Aaron, *Introduction*, in *The Value Added Tax* 1, 2 (H. Aaron ed. 1981); Barlow & Connell, *The Single Business Tax*, in *Michigan's Fiscal and Economic Structure* 673, 673 (H. Brazer ed. 1982) (methods "identically equal"); Haughey, *The Economic Logic of the Single Business Tax*, 22 Wayne L. Rev. 1017, 1018 (1976) ("equivalent methods"). That plainly was the understanding of those who drafted and administer the SBT: addition and subtraction are "two *alternative*, but *equivalent* ways of calculating value added. * * * The important point is that, conceptually, these two calculations are *equal*." Taxation and Economic Policy Office, Mich. Dep't of Treasury, *Analysis of the Michigan Single Business Tax* 20 (1985) (hereinafter cited as "*SBT Analysis*") (emphasis in original). See Pet. App. 10a. Michigan chose the addition method of computation simply as a convenience for taxpayers, because "taxpayers can use business income as required for federal business taxes as the starting point in the computation." *SBT Analysis* at 21. See Haughey, *supra*, 22 Wayne L. Rev. at 1025.

explicitly clear that the tax is a levy on what it meant to treat as a unitary course of business activity. In 1987 the SBT was amended to provide that "the apportionment provisions of this act shall fairly represent the business activity attributed to the taxpayer in this state, taken as a whole and without a separate examination of the specific elements of the tax base such as depreciation, compensation, or income." MCL § 208.69(3) (Supp. 1990). This amendment "express[ed] the original intent of the legislature that the single business tax imposed under the single business tax act * * * is an indivisible value added type of tax and not a combination or series of several smaller taxes." 1987 Mich. Pub. Acts 39, § 2, reprinted at Note to MCL § 208.69 (Supp. 1990).[11] The theory of the tax therefore is that it is impossible to identify the "value added" by isolated elements of a firm's business activity, a theory that makes formulary apportionment unavoidable.

The SBT thus includes values associated with all business activity (including sales) in the tax base,[12] and was

[11] The Michigan Supreme Court noted this amendment (Pet. App. 19a n.20, 27a n.29), although the court found it unnecessary to rely upon the statutory change in rejecting petitioner's contention that "'business activity' as defined under the act is susceptible to accurate analysis when only one component of the total business effort is examined." Pet. App. 23a. See also *id.* at 22a. For its part, the court of appeals below noted that under Michigan law the legislature "can amend a statute to make plain what the legislative intent had been all along from the time of the statute's enactment * * *. [The] timing indicates that the [1987] amendment was a legislative interpretation of the original act rather than a substantial change of it." Pet. App. 40a.

[12] In a sense, sales are the foundation of the SBT tax base. In calculating that base, "the starting point is business income" as reflected in the taxpayer's federal return. *Town & Country Dodge*,

written on the understanding that particular business activities (or, in petitioner's terms, particular increments of value added) are not segregable. Whether a theoretical VAT might regard sales as irrelevant, or might treat the value added by particular business activities as divisible—points we address below—accordingly is beside the point. The incidence of the tax actually at issue here, the SBT, is on petitioner's unitary course of business activity, and "[f]or constitutional purposes the decisive issue turns on the operating incidence of a challenged tax." *J.C. Penney*, 311 U.S. at 444. As the court below therefore explained, "to conclude that a taxpayer's business activity is not fairly apportioned because a single component of that activity, when viewed by geographical accounting, is not accurately reflected under the statutory apportionment scheme belies the very definition of business activity" in Michigan law. Pet. App. 22a.

With this understanding of the SBT, Michigan's three-part formula plainly does a constitutionally adequate job of apportioning the tax base upon which the levy expressly is laid. The tax in principal part is imposed upon "values" produced by activity involving sales, labor, and capital; given the incidence of the tax, "the averaged ratios of Trinova's payroll, property and sales 'actually reflect a reasonable sense of how [its Michigan business activity was] generated.'" Pet. App. 25a (bracketed

Inc. v. Department of Treasury, 362 N.W.2d 618, 623 (Mich. 1984). See *Mobil Oil Corp. v. Department of Treasury*, 373 N.W.2d 730, 732, 742 (Mich. 1985). Gross receipts are, in turn, the starting point in calculating federal business income; to derive an income figure for federal tax purposes, the taxpayer deducts specified expenses from gross receipts. Under the SBT, this process is then reversed; the taxpayer adds back to federal taxable income most expenses, principally those that were deducted from gross receipts in computing the federal income figure. See MCL § 208.9. See generally Kasischke, *Computation of the Michigan Single Business Tax: Theory and Mechanics*, 22 Wayne L. Rev. 1069, 1079-80 (1976). In the aggregate, these additions produce a tax base that is equivalent to gross receipts minus payments made to other business enterprises.

material added by the court) (citation omitted). Unless the Commerce and Due Process Clauses preclude the State from treating business activity as a unitary course of conduct, then, the SBT cannot be disturbed.

B. Costs Of Production Or Value Added Cannot Be Ascertained Through Geographical Accounting.

Although petitioner never comes to grips with the nature of the SBT as a tax on business activity,[13] the centerpiece of its assault on the apportionment of VATs generally is its contention that increments of added "value" may be—and therefore must be—taxed at the place where they are generated. "In this respect," petitioner adds, "the components of added value are conspicuously unlike the abstruse and elusive elements of profit that justify apportionment of net income" (Br. 26). This assertion is the crucial element both of petitioner's attempt to avoid formulary apportionment of the SBT tax base (see Br. 23-28) and its contention that the SBT taxes values that are added outside of Michigan (see Br. 31, 34-35).

At the outset, as respondent correctly notes (Resp. Br. 47-50), petitioner's attempt to equate the costs of production with particular increments of added "value" misstates the theory of the VAT. VATs typically are understood to operate on the principle that "[e]ach increment in *price* reflects the value added at that stage, with the value or price of the final product equal to the sum of the increments or values added at the various stages." R. Musgrave & P. Musgrave, *Public Finance in Theory and Practice* 400 (5th ed. 1989) (emphasis added). And that value—as reflected in price—has no necessary (and certainly no precise) correlation to the costs of production. The theory of VATs generally, as of the SBT in particu-

[13] Petitioner briefly notes that the court below treated the SBT as a tax on unitary business activity, labeling that court's analysis "simply inconsistent with the practical and intended effect of the tax." Br. 28. In fact, there can be no doubt that the Michigan Supreme Court correctly identified the intended incidence of the tax, which in terms reaches "business activity."

lar, accordingly is that taxable value is determined by the market's reaction to the enterprise's unitary course of business activity.[14]

But even if the case is viewed in petitioner's own terms, its analysis is fatally flawed, for petitioner never explains why costs of production differ in principle from the elements of profit that concededly cannot be confined geographically. And the omission is telling. In fact, the same factors that make it impossible to tie the generation of income to a particular location—centralization of management and purchasing, economies of scale, functional integration, and so on—also frustrate attempts to compartmentalize the costs associated with particular elements of business activity (or, to put it in petitioner's terms, the value added by such activity). In this case, for example, the existence of a reliable (and very large) market and distribution network for petitioner's goods in Michigan necessarily affected the efficiency with which petitioner was able to make use of its labor and capital further up the production chain; the price petitioner paid for labor in Ohio (the measure, in petitioner's view, of the value added there) turned in part on the scope and success of its sales activity in Michigan. This seems self-evident; it hardly is necessary to prove that "[a]n effective marketing operation is important to assure full or nearly full use of [production] capacities." *Exxon Corp.*, 447 U.S. at 226. Plainly, such efficiencies "arise from the

[14] The peculiarity of petitioner's concept of the VAT, in which costs of production are equated dollar-for-dollar with value added, is made clear by considering the case of a firm—like petitioner itself—whose costs of production exceed its value added because it had a net loss. In such a case, under petitioner's view, the "value" added to a product by application of the costs of production must somehow have been reduced by the failures of entrepreneurship that led to the net loss. It is difficult to imagine any coherent theory of value that produces such an effect. In fact, petitioner really seems to imagine that VATs are combinations of two wholly distinct taxes, one on profits and one on the costs of production. But that is not the usual understanding of the VAT and, as we explain above, plainly is not the theory upon which the SBT is imposed.

operation of the business as a whole." *Mobil Oil Corp.*, 445 U.S. at 438.

There is nothing novel in these observations. To the contrary, the very definition of the unitary enterprise "is that there be some sharing or exchange of *value* not capable of precise identification or measurement." *Container Corp.*, 463 U.S. at 166 (emphasis added). See *id.* at 178 (emphasis in original) ("The prerequisite to a constitutionally acceptable finding of unitary business is a flow of *value*"). As a result, geographical accounting "often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." *Id.* at 164-165.

In *Container Corp.*, the Court applied this understanding to reject a multinational taxpayer's argument that, because wage rates were lower at its overseas plants than at its domestic facilities, California's use of the three-factor apportionment formula allocated too much of the firm's income to the State. As the Court explained, it

> may well be that in addition to the foreign payroll going into the production of any given [item] by a foreign subsidiary, there is also California payroll, as well as other California factors, contributing—albeit more indirectly—to the same production. The mere fact that this possibility is not reflected in [the taxpayer's] accounting does not disturb the underlying premises of the formula apportionment method.

463 U.S. at 182. While petitioner asserts (for reasons that it nowhere explains) that the Court's observation has relevance only to taxes on profits (Br. 27-28), the important point for present purposes is what the Court itself has characterized as *Container Corp.*'s recognition that "the costs of a unitary business cannot be deemed confined to the locality in which they are incurred." *Amerada Hess*, 109 S.Ct. at 1622. In *Container Corp.*'s words, costs (or value added) other than those identified by geographical accounting may "go[] into the production of any given" good.

Indeed, only last Term the Court squarely held that, "just as * * * revenue—as part of a unitary business—is not confined to a single State * * *, so too the costs of producing this revenue are unitary in nature. See *Container Corp.*, 463 U.S. at 182." *Amerada Hess*, 109 S.Ct. at 1622. In *Amerada Hess*, unitary oil companies argued that they should be permitted to deduct from the income that was subject to taxation in New Jersey windfall profits taxes that they had paid on the production of oil out-of-state; "[t]hey argue[d] that the denial of a deduction for an out-of-state expense causes a State to tax more than its fair share of a unitary business' income." *Ibid.* But because the costs of a unitary business cannot be confined geographically, the Court held that, "when a State denies a deduction for a cost of a unitary business, the resulting net figure is still a unitary one." *Ibid.* See generally *Ford Motor Co. v. Beauchamp*, 308 U.S. 331 (1939).

Again, the significance of this holding for petitioner's argument is plain: costs of production—which, in petitioner's terminology, are the values added—cannot be localized. Just as the profit that a multistate firm derives from its retail outlet in Wisconsin might be boosted by economies of scale effected elsewhere (see *Exxon*, 447 U.S. at 225-227), so, too, at the other end of the process, petitioner's costs of production in Ohio surely are affected by the scope of its sales operation in Michigan. It accordingly is petitioner's scheme, in which increments of value would be "wrenched from the unitary whole and conceptually confined to operations within a single State" (*ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 333 (1982) (O'Connor, J., dissenting)), that would produce a grossly distorted system of apportionment.

C. Sales Are Crucial Components Of The Unitary Course Of Business Activity And May Be Used To Apportion Petitioner's Tax Base.

Similar problems inhere in petitioner's argument (Br. 30-31, 32, 33-34) that sales activity is irrelevant to the

concept of value added and therefore cannot be used as part of Michigan's apportionment formula. In fact, the Court has made clear that sales ratios have an appropriate role in apportionment precisely because, in combination with payroll and property, they "reflect a very large share of the activities by which value is generated." *Container Corp.*, 463 U.S. at 183. After all, as we explain above, sales and marketing are prerequisites to effective use of manufacturing facilities and a labor force. See, *e.g.*, *Exxon Corp.*, 447 U.S. at 226. Indeed, it seems self-evident that, in the most practical sense, many of petitioner's activities (or, more precisely, the 26.6% of petitioner's activities that terminated in Michigan sales) would be wholly value*less* to petitioner were it not for the market made available by Michigan. As a consequence, there is nothing unfair in Michigan's imposition of a tax on the appropriate portion of the values generated by those activities.

Petitioner's conduct of extensive sales activity in Michigan has special relevance to the nature of the due process guarantee that it invokes. In perhaps the Court's most oft-quoted comment on the nature of the constitutional limits on state taxing authority, it explained that "the sole constitutional test for a case like the present one" is "whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return." *J.C. Penney*, 311 U.S. at 444. And the State plainly has done that here, offering petitioner and its customers " 'police and fire protection, the benefit of a trained work force' " (*Amerada Hess*, 109 S.Ct. at 1624 (citation omitted)), "public roads" (*D.H. Holmes Co. v. McNamara*, 108 S.Ct. 1619, 1624 (1988)), and the other "fruits of civilization for which, as Mr. Justice Holmes was fond of saying, we pay taxes." *J.C. Penney*, 311 U.S. at 446.[15] It is these benefits provided

[15] See, *e.g.*, *Amerada Hess*, 109 S.Ct. at 1624; *D.H. Holmes Co.*, 109 S.Ct. at 1624; *ASARCO*, 458 U.S. at 315; *id.* at 332 (O'Connor,

by Michigan that make possible the continuing business operations that petitioner conducts elsewhere. This analysis plainly has application to the SBT, for "'[t]he logic or rationale of the [VAT] rests squarely on the benefit received principle of taxation—government services are essential to the operation of any business enterprise * * * and part of these public service costs should properly be included in the cost of doing business.'" Advisory Comm'n on Intergovernmental Relations, *The Michigan Single Business Tax: A Different Approach to State Business Taxation* 4 (1978) (citation omitted) (hereinafter cited as "*Michigan SBT*").

Against this background, it should come as no surprise that the Court already has upheld against constitutional attack another Michigan VAT that was virtually identical to the SBT. From 1953 until 1967 Michigan levied a Business Activities Tax that "employ[ed] as its measure or base the economist's measure of value added." Lock, Rau & Hamilton, *The Michigan Value-Added Tax*, 8 Nat'l Tax J. 357, 357 (1955). While that tax differed from the SBT in some particulars, its principle was the same: it included in the tax base "a company's payroll, profits, and capital outlay less depreciation allowed" (*id.* at 361), and it used the familiar three-factor formula to apportion the values of multistate firms. *Id.* at 363. See Mich. Stat. Ann. §§ 7.557(1)-(24) (1955 Cum. Supp.), repealed 1967 Mich. Pub. Acts 281.[16]

J., dissenting); *Exxon Corp.*, 447 U.S. at 228; *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 445 (1979).

[16] While the taxes differed in the exemptions they offered (none of which are relevant here), the principal substantive difference between the Business Activities Tax and the SBT lay in the area of depreciation. The SBT allows firms to exclude apportioned capital expenditures from the tax base in the year incurred (MCL § 208.23(a)); in subsequent years depreciation is included in the tax base. Under the Business Activities Tax, the initial capital expenditure was not excluded, but firms were permitted to exclude depreciation of real property in subsequent years. See Lock, Rau, & Hamilton, *supra*, 8 Nat'l Tax J. at 359-360; *Michigan SBT* at 17. The taxes also differed in their methods of computation. While the SBT adds together elements of the tax base, the Business Activities Tax used the subtraction method, starting with gross receipts and subtracting certain taxes, amounts paid other firms for raw materials, and real property depreciation. See *ibid.* As we explain above, however, the method of calculation has no effect either on the tax base or on the theory of the tax. See note 10, *supra*. The Business Activities Tax thus is consistently regarded as having been a form of VAT. See, *e.g.*, *Michigan SBT* at 17; Due, *Economics of the Value Added Tax*, 6 J. Corp. L. 61, 61-62 n.4 (1980); Haughey, *supra*, 22 Wayne L. Rev. at 1024, 1026; Lindholm, *The Origin of the Value-Added Tax*, 6 J. Corp. L. 11, 12 & n.10 (1980); Lock, Rau & Hamilton, *supra*, 8 Nat'l Tax J. at 357. In addition, the Business Activities Tax, like the SBT, allowed the taxpayer, at its option, to use as the tax base 50% of its gross receipts apportioned to Michigan. See *id.* at 360.

In a case bearing remarkable similarities to this one, the Business Activities Tax was challenged on Due Process and Commerce Clause grounds by an Ohio corporation that paid less than 1/1000 of its payroll, and had less than 1/40,000 of its property—but made almost 10% of its total sales—in Michigan. See *Armco Steel Corp. v. Department of Revenue*, 102 N.W.2d 552, 555-556 (Mich.), app. dismissed, 364 U.S. 337 (1960). Noting that the tax actually levied on the Ohio firm amounted to only about 1/10 of one per cent of its Michigan sales, the Michigan Supreme Court held that "[t]his is not an unreasonable tax on business activities in Michigan. The tax as apportioned bears a real and reasonable relationship to the privileges, opportunities and protection [the taxpayer] enjoys in conducting its interstate business in this State." *Id.* at 563. This Court found so little merit in the taxpayer's challenge to the state court's conclusion that it dismissed the appeal for want of a substantial federal question. 364 U.S. 337 (1960). That judgment should be dispositive of petitioner's essentially identical arguments here.

D. The SBT Should Be Upheld As A Variant Of A Concededly Constitutional Gross Receipts Tax.

1. The wholly artificial nature of petitioner's contentions is made clear by its concession (Br. 35-36)—a concession compelled by this Court's decisions—that Michigan's tax would be immune from constitutional attack were it labeled a tax on gross receipts. As the Court has noted in similar circumstances, in response to a challenge to an Iowa income tax, "it would be an exercise in formalism to declare [the taxpayer's] income tax assessment unconstitutional * * *. For it is evident that [the taxpayer] would have had no basis for complaint if, instead of an income tax, Iowa had imposed a more burdensome gross-receipts tax on the gross receipts from sales to Iowa customers." *Moorman*, 437 U.S. at 280. See *id.* at 281 (Brennan, J., dissenting) ("I agree with the Court that, for purposes of constitutional review, there is no distinction between a corporate income tax and a gross-receipts tax.").

The Court has, of course, repeatedly sustained state authority to impose gross receipts and similar taxes on the in-state sales of multistate businesses.[17] Yet such taxes are considerably more burdensome than the SBT: they need not be apportioned at all. See, *e.g.*, *Goldberg v. Sweet*, 109 S.Ct. 582, 589-591 (1989). In this light, the SBT, which is equivalent to a tax of less than 3/10 of one per cent of the gross receipts from petitioner's Michigan sales (see Pet. App. 7a), is hardly excessive. Compare *Moorman*, 437 U.S. at 280; *Armco*, 102 N.W.2d at 562.

Relying on *McLeod v. J. E. Dilworth Co.*, 322 U.S. 327 (1944), in which the Court struck down a state sales tax despite the State's authority to impose an equivalent use

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[17] See, *e.g.*, *Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue*, 483 U.S. 232, 243 (1987); *Complete Auto*, 430 U.S. at 289; *Standard Pressed Steel Co. v. Washington Revenue Dep't*, 419 U.S. 560, 564 (1975); *General Motors Corp. v. Washington*, 377 U.S. 436, 448 (1964); *McGoldrick v. Berwind-White Coal Mining Co.*, 309 U.S. 33, 58 (1940). Cf. *Goldberg v. Sweet*, 109 S.Ct. 582, 589-591 (1989); *National Geographic Society v. California Board of Equalization*, 430 U.S. 551, 557 (1977).

tax, petitioner nevertheless takes issue with *Moorman's* analysis, asserting that the SBT cannot be validated by the availability of some alternative constitutional tax. But as petitioner elsewhere acknowledges (Br. 28), the Court has since departed from the formalistic approach of holding the label on the tax dispositive, looking instead to the practical operation of a tax and eschewing rules that "stand[] only as a trap for the unwary draftsman." *Complete Auto*, 430 U.S. at 279. See *id.* at 288; *J.C. Penney*, 311 U.S. at 444. *Moorman* accordingly reflects the Court's current thinking, and there is no reason to depart from its eminently practical analysis.

Indeed, the Court's observations in *Moorman* have particular resonance in this case because the SBT may fairly be viewed, in its practical operation, as a form of tax on gross receipts. While a VAT has some relationship to a tax on income, as we explain below, in effect "[a] value-added tax is a multistage sales tax." 3 *Tax Reform* at 5. See *id.* at 14. Economists almost uniformly agree that "the value-added tax is not a genuinely new form of taxation but merely a sales tax administered in different form." R. Musgrave & P. Musgrave, *supra*, at 399. Thus, "[i]t is essential for an understanding of the value added tax to note that the levy is identical to a retail sales tax of equivalent coverage and rate in both revenue and distribution of the tax burden." Due, *supra*, 6 J. Corp. L. at 62. See, *e.g.*, *R.* Musgrave & P. Musgrave,, *supra*, at 401; Carlson, *Value-Added Tax: Appraisal and Outlook*, 6 J. Corp. L. 37, 38 (1980); McDaniel, *A Value Added Tax for the United States? Some Preliminary Reflections*, 6 J. Corp. L. 15, 16-17 (1980). See generally C. Sullivan, *The Tax on Value Added* 6, 209 (1965). The reason is plain: whether computed through addition or subtraction, the tax base of a pure VAT will include most of the costs of production in combination with profit (or loss), an amount that necessarily bears a close relationship to—but typically will be somewhat less than—gross income. See, *e.g.*, R. Musgrave & P. Musgrave, *supra*, at 402 ("the value-added

tax of the consumption type has the same base as a retail sales tax with corresponding coverage").[18]

For their part, the drafters of the SBT plainly understood that its real incidence has a close relationship to that of a gross receipts tax. Indeed, as "an alternative tax computation method" (*SBT Analysis* at 38), the SBT provides that, if a firm's adjusted tax base exceeds 50% of gross receipts apportioned to Michigan, "the adjusted tax base may, at the option of the taxpayer, be reduced by such excess." MCL § 208.31(2). As a result, no firm's tax base may exceed 50% of its Michigan sales[19]; because the SBT rate is 2.35%, no firm's tax liability ever should exceed 1.175% of its gross receipts. See *SBT Analysis* at 38.[20]

To be sure, petitioner insists that this element of the SBT is irrelevant, labeling it a "departure[] from a 'pure' VAT" and stating that most Michigan taxpayers compute their tax base "without reference to their gross receipts." Br. 37. "Pure" VATs, however, are most often conceptualized as involving use of the subtraction method of computation, which uses gross receipts as its starting point.[21] Moreover, as we note above—and as petitioner elliptically

[18] For a fully integrated company that owns its own raw materials and produces its own capital equipment, the "value-added tax base would be simply its net sales." Smith, *supra* at 78. For non-integrated firms, of course, the base would be equivalent to gross receipts less purchases from other enterprises that have added value to the product.

[19] Petitioner states that "for some taxpayers (but not for petitioner) the tax base is reduced" to 50% of apportioned gross receipts. Br. 37. In fact, petitioner could have used the gross receipts option but declined to do so, instead taking advantage of another deduction that permits a firm with high labor costs to reduce its adjusted tax base by the percentage that its compersation divided by its unadjusted tax base exceeds 63%. MCL § 208.31(5). See Pet. App. 13a n.13.

[20] In fact, for all firms, the SBT averages 0.4% of sales. *SBT Analysis* at 7.

[21] See, *e.g.*, 3 *Tax Reform* at 5; Smith, *supra*, at 78.

acknowledges (Br. 5)—the addition and subtraction methods of computation are interchangeable and yield identical results; the SBT uses the addition method simply as a convenience for taxpayers. See note 10, *supra*. This accounting technicality cannot change the nature of the economic values reflected in the tax base.

In *McLeod's* terms (assuming *McLeod* remains the law), then, one may "look[] behind the labels to the thing described," and validate the tax if "the thing * * * [does] not offend the Federal Constitution." 322 U.S. at 331. The "thing" here is a levy whose base is identical to that of a modified, and plainly constitutional, tax on gross receipts. Under such circumstances, invalidating the SBT would be an exercise in the most wooden semanticism.

2. It should be added that there are other ways of viewing the SBT that also support use of formulary apportionment. In its ultimate economic effect a VAT is similar to a tax on all of the income generated by the taxpayer's business activity. As the Michigan Supreme Court itself has explained, "[i]t is apparent that the income tax and the VAT are in reality opposite sides of the same coin" because, "[p]ractically speaking, the main difference between an income tax and a VAT can be determined by examining *who* is a taxpayer under each system." *Mobil Oil*, 373 N.W.2d at 740 (emphasis in original).[22] Because it is the firm's unitary activities that are responsible for the production of all of this income, formulary apportionment is an appropriate method of taxing it.

Having said this, however, in our view the Court should not attempt to resolve this case by applying highly ab-

[22] This is so because the value generated by the enterprise may be characterized as income received (or lost) by someone else: labor costs are equivalent to income received by employees, capital costs are translated into rent and interest received by landlords and lenders, and so on. See *Mobil Oil*, 373 N.W.2d at 740. More precisely, a consumption-type VAT, as its name suggests, uses total consumption as its tax base because it does not exclude depreciation. See Smith, *supra*, at 79; 3 *Tax Reform* at 7.

stract economic concepts—as petitioner urges by propounding one economist's (rather idiosyncratic) concept of where value is added. See Br. 26 (citing Barlow & Connell, *supra*, at 704). Economists differ among themselves on, among many other things, how best to characterize the value added tax. See Note, *Value-Added Taxation: Its Concept and Effects*, 39 U. Cin. L. Rev. 331, 334-335 (1970). Resolution of these conflicts in economic theory is an " 'essentially legislative task' " (*Goldberg*, 109 S.Ct. at 588 (citation omitted)) that is not easily undertaken by the courts. See *ASARCO*, 458 U.S. at 352 (O'Connor, J., dissenting). And needless to say, particular economic theories may not be reconcilable with this Court's understanding of the Constitution.[23] In these circumstances, it would be appropriate for the Court to accept the characterization of the VAT provided by the Michigan Legislature, and to be guided by the levy's practical similarity to (if not identity with) taxes that already have been held constitutional.

II. THE SBT DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE.

Petitioner's remaining argument (Br. 38-44)—that the SBT discriminates against out-of-state firms—is wholly without merit. At the outset, petitioner finds it somehow suspect that the SBT was designed, in part, to encourage the development of Michigan business. Br. 38,

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[23] This is true, for example, of the economic analysis upon which petitioner principally relies. Among other things, that analysis takes Michigan's apportionment formula to task for "giving equal weight to the labor and capital aspects of a firm's activities, when in fact those inputs are often very unequal." Barlow & Connell, *supra*, at 704. But this Court, of course, has long upheld use of apportionment formulas that give equal weight to payroll and property ratios, without inquiry into the nature of a particular firm's activities. It may be added that the economic analysis cited by petitioner concludes that consumption-type VATs "clearly introduce[] a bias favoring capital-intensive methods" (*id.* at 697); most economists, in contrast, regard consumption-type VATs as neutral between capital and labor. See, *e.g.*, 3 *Tax Reform* at 7.

43. But the Court has made clear that States may "structur[e] their tax systems to encourage growth and development of intrastate commerce and industry," rejecting the contention that "a State may not compete with other States for a share of interstate commerce; such competition lies at the heart of a free trade policy." *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 336-337 (1977). See *Armco Inc. v. Hardesty*, 467 U.S. 638, 645-646 (1984). The Commerce Clause thus does not "inhibit a State's power to experiment with different methods of encouraging local industry. Whether the encouragement takes the form of a cash subsidy, a tax credit, or a privilege intended to attract investment capital, it should not be characterized as a 'burden on commerce.' " *Hughes v. Alexandria Scrap Co.*, 426 U.S. 794, 816 (1976) (Stevens, J., concurring).

Indeed, the SBT was designed to spur Michigan industry simply by reducing the excessive tax burden that the State previously had imposed on capital. See *SBT Analysis* at 19; *Michigan SBT* at 13, 20. Consumption-type VATs are neutral as between labor- and capital-intensive industries. See, *e.g.*, 3 *Tax Reform* at 5-7. In contrast, "[a]ll of the taxes repealed [upon enactment of the SBT] were strictly on capital." Haughey, *supra*, 22 Wayne L. Rev. at 1022. See Mitchell, *Taxes Repealed and Amended*, 22 Wayne L. Rev. 1029 (1976). Although it was hoped that the SBT accordingly would encourage capital investment in the State, it also was understood that "some labor intensive industries with regional or national markets [might] leave Michigan" in response to the new tax. Haughey, *supra*, 22 Wayne L. Rev. at 1022. But in either case, "these results are due to the shift from one system to another and are not inherent in the nature of the SBT." *Id.* at 1023. This redesign of the State's tax system along lines of neutrality is hardly unconstitutional; any disparate effects that the SBT has on different firms "results solely from differences between the nature of their businesses, not from the location of their activities." *Amerada Hess*, 109 S.Ct.

at 1624. See *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117, 125-129 (1978).[24]

Using a complex hypothetical (Br. 39-41), petitioner also attempts to demonstrate that use of a sales factor in Michigan's apportionment formula discriminates against out-of-state businesses because it "systematically underattributes to Michigan the site-specific tax base components—compensation and depreciation—of in-state businesses while systematically overattributing to Michigan those same site-specific tax base components of out-of-state businesses." Br. 43. Of course, just who is the victim of this asserted discrimination depends on which ox is being gored; Michigan businesses, viewing the SBT as a form of gross receipts tax, might argue that *they* suffer under the tax because non-Michigan firms are able to apportion some of their Michigan sales out-of-state, while some out-of-state sales by Michigan firms are apportioned back in-state. And even viewing the issue in petitioner's own terms, whether or not a firm benefits from use of a sales factor in apportionment of the SBT turns on whatever varying values are plugged into petitioner's hypothetical.

More fundamentally, however, petitioner's argument is not really one of disparate treatment at all. Petitioner's claim of discrimination rests entirely on the validity of its prior assertions that the costs of production are, in fact, "site-specific," and that sales have no relationship to value added. Once it is understood that the SBT falls on a unitary course of business activity that includes both production and sales, it is evident that neither out-of-state nor Michigan firms have any ground to complain

[24] Petitioner finds support (Br. 43-44) for its claim in what it labels the SBT's discriminatory capital acquisition deduction, which apportions the cost of capital assets under a two-part payroll and property formula. MCL § 208.23(a). As petitioner notes, however, the constitutionality of that provision is not at issue here; as the deduction provision's apportionment formula differs from the one under attack by petitioner, the provision plainly has no bearing in this case.

about the statutory apportionment formula because values are transferred neither into nor out of the State.

This comes clear from consideration of the decisions relied upon by petitioner to establish discrimination. See Br. 41-43. In most of them, the state tax statutes at issue were "facially discriminatory" (*Amerada Hess*, 109 S.Ct. at 1623); they imposed burdens (through higher tax rates or lower credits) on out-of-state sales that were not imposed on in-state sales. See *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 393-394, 400, 403-404 (1984); *Maryland v. Louisiana*, 451 U.S. 725, 732-734, 756-758 (1981); *Boston Stock Exchange*, 429 U.S. at 324-325; *Halliburton Oil Well Co. v. Reily*, 373 U.S. 64, 67-68, 70, 73 (1963). That plainly is not true of the SBT, which taxes all business activity at the same rate, wherever it occurs. The remaining decision cited by petitioner, *American Trucking Ass'ns v. Scheiner*, 483 U.S. 266 (1987), involved a flat tax that failed the Court's "internal consistency" test because, if adopted by every jurisdiction, it would have discouraged interstate activity. See *id.* at 284; *Amerada Hess*, 109 S.Ct. at 1623. But because petitioner does not deny that the SBT passes the test of internal consistency (see Pet. App. 18a-19a),[25] *Scheiner* is irrelevant here.

The SBT thus does not "exert[] 'an inexorable hydraulic pressure on interstate businesses to ply their trade within the State that enacted the measure.'" *Amerada Hess*, 109 S.Ct. at 1623, quoting *Scheiner*, 483 U.S. at 286-287. If all States adopted taxes identical to the SBT, interstate activity would not be discouraged. And a business that moves to Michigan will find itself with higher Michigan payroll and property ratios and, accordingly, a higher Michigan tax bill. Of course, Michigan

[25] That is evident from petitioner's example. If Ohio and Michigan each imposed taxes identical to the SBT on petitioner's hypothetical businesses, the tax burdens on the two firms also would be identical and the tax structure would not create any incentive for either firm to operate in one State rather than the other.

may succeed in wooing firms by reducing tax rates on capital below those prevailing in other States, but any advantage it gains from that approach will come because its tax rates are low, not because they are discriminatory. That is a wholly constitutional means of competing for interstate business.

If we are correct, as we argue above, that business activity may be viewed as a unitary and apportionable course of conduct, petitioner's claim of discrimination ultimately amounts to a bald attack on the inclusion of a sales factor in *any* apportionment formula. But the Court has made clear that sales factors are an appropriate part of the gauge of in-state business activity; the Court has, for that matter, upheld use of a *single-factor* apportionment formula based on sales. *Moorman*, 437 U.S. at 277. Michigan's three-factor formula accordingly is a reasonable and nondiscriminatory—indeed, a commendably moderate—means of apportioning interstate business activity.

CONCLUSION

The judgment of the Michigan Supreme Court should be affirmed.

Respectfully submitted,

BENNA RUTH SOLOMON *
Chief Counsel
CHARLES ROTHFELD
STATE AND LOCAL LEGAL CENTER
444 North Capitol Street, N.W.
Suite 349
Washington, D.C. 20001
(202) 638-1445

* *Counsel of Record for the* Amici Curiae

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